LIBRARY
SUPREME COURT, U. S.

FILED
DEC 9 1967
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1967

No. 897

TRANS WORLD AIRLINES, INC.,
Petitioner,

v.

CIVIL AERONAUTICS BOARD,
Respondent.

APPENDIX B TO PETITION FOR CERTIORARI

CHARLES PICKETT,
CARL S. ROWE,
25 Broadway,
New York, N. Y. 10004,
Counsel for Petitioner.

INDEX

	PAGE
Order E-22022, dated April 12, 1965	B1
Order E-8833, dated December 20, 1954 (19 C. A. B. 464)	B118
Order E-10117, dated March 23, 1956 (23 C. A. B. 307, 312)	B439

Appendix B

ORDERS OF THE CIVIL AERONAUTICS BOARD

E–22022

UNITED STATES OF AMERICA

CIVIL AERONAUTICS BOARD

WASHINGTON, D. C.

Docket 1706 *et al.*

REOPENED TRANSATLANTIC FINAL MAIL RATE CASE

Decided: April 12, 1965

The fair and reasonable final mail pay for the international operations of Trans World Airlines, Inc., for the period February 5, 1946 through December 31, 1953, after offsetting excess earnings of $2,859,000 from its domestic operations for the periods February 5, 1946 through March 13, 1947 and January 1, 1951 through December 31, 1953, and after taking account of the tax credit, is $48,633,000.

Two-thirds of the losses caused by the 1953 navigator strike resulted from failures of honest, economical, and efficient management, and are therefore disallowed for all purposes.

The remainder of the losses caused by the 1953 navigator strike and all of the losses caused by the 1946 pilot strike were incurred under honest, economical, and efficient management, and are recognized in computing the break-even need of the carrier's international operations.

References in **bold** type are to pages in the Record.

A fair and reasonable rate of return for the carrier's international operations during the period under review, eliminating the risk of strike losses, is seven percent.

In screening the results of carrier's domestic operations for offset purposes, its 1946 strike losses are recognized in computing its domestic break-even need.

A fair and reasonable rate of return for offset purposes for the carrier's domestic operations during the offset period defined herein, eliminating the risk of strike losses, is eight percent.

Accruals to a reserve for taxes deferred due to accelerated amortization, not representing taxes actually paid by the carrier, are not allowed as a proper tax expense in determining domestic earnings during the offset period.

16681

The rate fixed herein is subject to adjustment to reflect properly such actual tax credits as may ultimately accrue to the carrier as a result of the payback required hereby.

APPEARANCES:

Same as in initial decision, and also

Thomas F. Meagher, Jr., for the Postmaster General.

16682

OPINION OF THE BOARD

By BOYD, Chairman:

We have before us for decision, on remand by the courts, the last remaining phase of the *Transatlantic Final*

Mail Rate Case, involving a determination of the proper mail compensation for the international operations of Trans World Airlines, Inc., for the period February 5, 1946, through December 31, 1953.

A brief review of the prior proceedings in the case will assist in understanding the specific issues that we must here decide.[1] The *Transatlantic Final Mail Rate Case* was a consolidated proceeding directed to fixing final mail rates for the transatlantic operations of the three United States air carriers who were then providing such services.[2] As to TWA, the only carrier with which we are here concerned, the mail rate to be established embraced the entire early life of its scheduled transatlantic services which were inaugurated on February 5, 1946. Since the Board at that time followed the general practice of fixing separate rates for the international and domestic operations of multidivisional carriers like TWA, the proceeding did not include any issue going to the mail rates for TWA's

16683

domestic operations.[3]

After hearings and all other procedural steps in the proceeding had been completed but before the Board had issued a final decision, the United States Supreme Court handed down its decision in *Delta Air Lines* v. *Summerfield,* 347 U.S. 74 (1954). The Court there held that under

---

1 *Transatlantic Final Mail Rate Case,* 19 C.A.B. 464 (1954), 21 C.A.B. 484 (1955), 23 C.A.B. 307 (1956), 28 C.A.B. 959 (1958).

2 In addition to TWA, the carriers involved were American Overseas Airlines and Pan American World Airways. Final transatlantic mail rates for the two latter carriers have since been established, and they are no longer in the case. Order E-18072, March 5, 1962.

3 In *American Air et al., Mail Rates,* 14 C.A.B. 558 (1951), the Board established final mail rates for TWA's domestic operations. Under that order, effective January 1, 1951, the carrier's domestic operations were placed on a future service rate that provided just compensation for transporting the mail, but contained no element of subsidy based upon "need." TWA has remained on a service rate domestically at all times since then.

the Act the Board in fixing subsidy rates must do so on the basis of the "need" of the carrier as a whole, and that, accordingly, in fixing rates for the foreign operations of a carrier having both foreign and domestic operations, the Board is required to offset any "excess" earnings from the carrier's domestic operations against the "need" of its foreign operations. In the light of the court's decision in *Delta*, the Board reopened the proceeding for further hearings on the question of whether TWA's domestic division had any excess earnings that should be offset against the "need" of its international division in determining the mail rate for its transatlantic operations.[4]

Thereafter, the Board issued its decision in the so-called "transatlantic phase" of the case, in which it disposed of all issues relating to the fixing of the rate of TWA's transatlantic operations,

16684

as such.[5] After further hearings and appropriate procedural steps, it subsequently also issued its decision in the so-called "offset phase" of the case, in which it determined the excess earnings of TWA's domestic division, and applied that excess to the need of the international division as previously determined to arrive at TWA's final transatlantic mail rate for the 1946-1953 period.[6]

In the course of its decisions disposing of the numerous issues in the proceeding, the Board among other things

---

4 *Transatlantic Final Mail Rate Case*, 19 C.A.B. 632 (1954).

5 *Transatlantic Final Mail Rate Case*, 19 C.A.B. 464 (1954), reaffirmed, 21 C.A.B. 484 (1955). The Board established January 1, 1954, as the cut-off date between the past and prospective rate periods for the carrier's international operations; fixed a "need" mail rate for these operations during the past period February 5, 1946-December 31, 1953, subject to such adjustments as might be called for by its determinations on the offset issue; and fixed a final future service mail rate for these operations after December 31, 1953. TWA has remained on a service mail rate internationally at all times since December 31, 1953.

6 *Transatlantic Final Mail Rate Case, Reopened*, 23 C.A.B. 307 (1956).

refused to recognize as part of the carrier's break-even need, in both the transatlantic and offset phases, strike losses incurred by TWA's international and domestic divisions during the past period under review, primarily on grounds (a) that as a matter of general policy the Board should not attempt to assess strike fault or to intervene in labor disputes on the side of either management or labor, and (b) that the risk of strike losses should in any event be borne by the carrier's rate of return on investment, rather than by its break-even need. In the offset phase, the Board also refused to recognize as a deduction in computing the excess earnings of TWA's domestic division the accruals to a "deferred" tax reserve set up by TWA on the books of its domestic

division that were designed to meet anticipated tax liabilities expected to accrue in future years as a result of accelerated amortization of emergency facilities which the carrier had acquired. The effect of these two determinations was to decrease the need of TWA's international division and to increase the excess earnings of its domestic division that were available for offset against this need.

Upon appeal by TWA from the Board's orders, the court, without passing on any part of the merits of the appeal, vacated the orders as to TWA and remanded the case to the Board for further consideration on the ground that the then Chairman of the Board, who was one of the three-member majority voting not to allow TWA's tax-reserve accruals as an expense in the offset phase, should have disqualified himself because, in his prior capacity as Solicitor of the Post Office Department, he had signed a brief to the Board dealing with other issues in the case.[7]

---

[7] *Trans World Airlines v. Civil Aeronautics Board*, 254 F. 2d 90 (C.A.D.C. 1958).

On the same day, the court in a companion case involving an appeal by American Overseas Airlines from the same set of orders vacated those orders as to AOA and remanded the case to the Board for further proceedings on the ground, *inter alia*, that under the Act the Board could not disallow strike losses as a matter of general policy, but must determine the proper treatment of such losses on the basis of appropriate findings of fact under the specific mail-rate

16686

standards set forth in section 406 of the Act.[8]

Following these two court decisions, the Board reopened the *Transatlantic Mail Rate Case* for further hearings on the question of the extent, if any, to which TWA's subsidy mail rates for 1946-53 should include allowances for losses caused by its 1946 pilot strike and its 1953 navigator strike, and for deferred taxes related to the accelerated amortization of its equipment.[9] It is those two questions which must be resolved here.

Public hearings were held before Examiner James S. Keith, who thereafter issued his initial decision in which he found that the losses resulting from the 1946 pilot strike and the first four days of the 1953 navigator strike should be recognized as an expense in computing TWA's

---

8 *American Overseas Airlines* v. *Civil Aeronautics Board*, 254 F. 2d 744 (C.A.D.C. 1958). The grounds for the Board's refusal to recognize the AOA and the TWA strike losses were identical; all parties presented the strike-loss issue to the court as a single question of law governing the appeals of both carriers; and nothing in the court's decision suggests an intent to limit its scope to the situation of AOA alone.

9 *Transatlantic Final Mail Rate Case, Reopened*, 28 C.A.B. 959 (1958). The Board also included as an issue in the reopened proceeding a third question as to the amount that should be allowed TWA for capitalized interest on equipment-purchase funds. The parties by stipulation agreed on the disposition of that issue, the examiner adopted that disposition in his initial decision, and the Board did not grant review. Accordingly, the issue is not before us, except to the extent that the disposition which has been made of it must be taken into account in computing the dollar amount of TWA's final mail pay.

break-even need, but that the losses from the remaining period of the navigator strike should be disallowed under the statutory standard of honest, economical, and efficient management; that the

16687

rate of return for TWA's transatlantic operations should be reduced from the 7 percent previously fixed by the Board to 6.9 percent, in order to compensate for the removal of the risk of strike losses from that rate; and that TWA's accruals to its deferred tax reserve should be recognized as an expense. The Board exercised its right of discretionary review as to both the strike-loss and the deferred-tax issues.[10] All parties filed briefs and the Board heard oral argument.

Upon consideration of the record and the contentions of the parties, we find that we are in agreement with the examiner's ultimate conclusion that all of TWA's 1946 strike losses and one-third of its 1953 strike losses should be recognized in computing its break-even need but that the balance of its 1953 strike losses should be disallowed. However, we conclude that the rate of return for TWA's transatlantic operations should not be reduced to 6.9 percent as proposed by the examiner, and that accruals to its deferred tax reserve should not be recognized as an expense. Even as to the issues on which we agree with the examiner's ultimate conclusions, our reasons for arriving at these conclusions differ from his in material respects, which we now proceed to discuss. The portions of the examiner's initial decision which we adopt as our own, except as modified herein, are attached hereto as Appendix A.

---

10 Bureau counsel sought review of the examiner's determinations on both issues; TWA sought review only of the examiner's partial disallowance of its 1953 strike loss and his reduction of its international rate of return to 6.9 percent; the Postmaster General sought review only of the examiner's allowance of the carrier's deferred-tax accruals.

The Strike Loss Issue

All parties agree that the court's decision in the *AOA* case, *supra,* is practically, even though perhaps not technically, controlling here. As is discussed later, the parties advance conflicting views as to what the AOA decision requires of the Board. However, out of the conflicting interpretations of that decision, two points emerge with clarity and are agreed to by all parties. First, in determining the treatment of TWA's strike losses for subsidy computation purposes, we are to give no consideration to the possible effects of our determination on the bargaining position of labor or management in future labor disputes. We accept the court's ruling on this point, and have excluded all such matters from our consideration.

Second, if we find on the record before us that either or both of the strikes which TWA experienced would not have occurred, or would not have continued, under honest, economical and efficient management, then to that extent we are barred by the express language of the statute from making any allowance for the losses thus incurred in computing the carrier's need for subsidy. Accordingly, we will proceed to assess TWA's management performance in connection with these two strikes.

Honest, economical, and efficient management. During the review period TWA suffered two strikes. The first, which occurred in 1946, involved its pilots, and resulted in a total cessation of all of the carrier's services—both international and domestic—for 25 days. The second, which occurred in 1953, involved its navigators, and affected the carrier's international services for 12 days.

The examiner's description of the events leading up to and surrounding both the 1946 pilot strike and the 1953 navigator strike is clear and comprehensive, and we adopt it as our own. We also adopt his conclusion that the cost of the pilot strike and the first four days of the navigator strike was not the result of any lack of honest, economical, and efficient management on the part of TWA, but that the cost of the remaining period of the 1953 strike was attributable to a lack of economical and efficient management on the carrier's part. We wish to add only a few comments of our own on this issue.[11]

Unlike the examiner, we are not so certain that TWA's insistence in 1946 on industry-wide bargaining through the Airline Negotiating Committee (ANC), in the face of strong opposition by the Air Line Pilots Association (ALPA), which represented the TWA pilots, to any change in the existing pattern of individual carrier negotiations, was a wise act. Further, we cannot accept the argument that, because the Board approved under section 412 the agreement among carriers setting up ANC, TWA was therefore justified in insisting on industry-wide bargaining. The Board's approval of the organization of ANC signified no more than that it found the agreement

---

11 On brief, bureau counsel argues that the burden of proof on the issue of honest, economical, and efficient management is on the carrier and that TWA has here failed to meet this burden; he takes exception to the failure of the examiner to rule on this issue. In response, TWA cites language from the *AOA* decision which, it insists, places the burden on bureau counsel to demonstrate a lack of proper management. The issue of burden of proof was not before the court in *AOA*, and we do not believe the court intended to express an opinion on this point. Accordingly, we reaffirm our long-standing rule that the burden of proof as to honest, economical, and efficient management is on the carrier, but find that, to the extent noted above, TWA has sustained that burden.

in question not to be in and of itself contrary to the public interest.

If the strike had occured during the period when TWA was refusing to bargain individually with ALPA, we might very well have found a disqualifying lack of economical and efficient management. In the actual event, however, even if TWA's earlier insistence on industry-wide bargaining was unwise, there is no substantial basis for concluding that this insistence was a material cause of the strike which actually took place.

Clearly, the immediate cause of the strike was ALPA's desire to enforce its demands for wage increases greatly in excess of those recommended by the Emergency Board, and not TWA's earlier insistence on industry-wide bargaining. If TWA had bargained individually with the union throughout, the strike might have taken place at a different time, but would in all probability have taken place nonetheless, and over exactly the same issue of wage increases. It is equally plain that no criticism can be leveled at TWA's management for refusing to yield to the union's ultimatum or grant its demands. Whatever our views on the wisdom of TWA's stand on industry-wide bargaining, those views cannot affect our allowance or disallowance of TWA's strike losses in the absence of a finding of proximate causation linking the one to the other. The record here clearly establishes the absence of such causation.

Turning to the navigator strike, we agree with the examiner that the strike was an illegal one, called in violation of the no-strike pledge in the collective bargaining agreement between TWA and the Air Line Navigators Association (ALNA), not in response to any violation by TWA of the agreement, and not even in accordance with the union's own strike procedure. At all

times prior to and during the strike, TWA acted strictly in accordance with its legal and contractual rights and obligations, whereas ALMA did not. From this standpoint, therefore, the blame for the strike must fall entirely upon the union.

But good labor relations is not simply a matter of strict observance of and insistence upon legal and contractual rights and duties; it is a matter also of relations among human beings, and due account must be taken of ordinary human attitudes and emotions. Here, the navigators were well aware that their jobs were ultimately forfeit, since their union had signed an agreement which left TWA free to abolish their jobs and furlough them as ground navigation aids became available. Plainly, however, no agreement could make them happy with this situation.

TWA must have known this, and must have known also that the actual commencement of operations without navigators on the European route segments would be a particularly critical time, when the emotions of the navigators would be most likely to result in some outbreak. At such a time, we think, wise management would have made an exceptional effort to soothe the feelings of its employees. TWA could have done a great deal in this direction, without waiving any portion of its legal or contractual rights, simpy by taking ALNA into its confidence as to the details of its plans for the gradual changeover to operations without navigators.

In particular (and this is the only point we would add to the examiner's findings of fact), it appears that TWA's management knew on or about July 1, 1953—about the time it discontinued the use of navigators on the Paris-Rome

segment, and about ten days before the strike began—that it would not in fact be necessary to furlough any navigators at this time or for an indefinite future period. In all probability, if the navigators had been aware of this fact, the strike would not have taken place, or at least would not have taken place when it did. Yet there is no evidence in the record before us that TWA made any effort to acquaint ALNA with this fact. Instead, when the union itself requested a meeting to discuss its problems, TWA appears to have assigned the whole matter a rather low priority, deferring the request and routing it "through channels."

In short, while the immediate cause of the strike was the unreasonable demand by ALNA for a job security which it had already knowingly relinquished, and its unfounded assertion that TWA was violating the collective bargaining agreement, still we cannot escape the conclusion that a contributing cause was the carrier's failure to use all reasonable means to avert a work stoppage, specifically by taking the navigators into its confidence as to its plans for their future.

We do not think, however, that this conclusion requires us to disallow TWA's strike losses *in toto*. The basic cause of the strike was the navigators' understandable but unjustified desire to keep their jobs indefinitely, and this TWA could not have conceded consistently with its obligation to avoid wasteful and unnecessary expense. Ultimately it did become necessary to phase out the navigators, and there certainly is a substantial possibility that, had a strike been avoided in 1953, it would nevertheless have occurred at this later time. Accordingly, we think that fairness requires that we attribute

only a fraction of the cost of the 1953 strike to the failure of economical and efficient management on TWA's part. What fraction, of course, is a matter of judgment.

Once the strike had begun, we agree entirely with the examiner that it was unnecessarily prolonged by TWA's intransigence. It is apparent from the testimony that, within a very short time after their walkout, the navigators realized its futility; thereafter, their primary concern was to return to work under circumstances which would not leave those individual navigators who had responded to the strike call by refusing their flights to bear the whole brunt of the consequences of the union's collective action. ALNA's request for reinstatement of the discharged navigators was not an unreasonable one, even though the strike itself was illegal; TWA in fact acceded to this request in the ultimate settlement of the strike. As the examiner found, if TWA had not so long continued to insist on what amounted to unconditional surrender on the union's part, it could have achieved precisely the settlement it ultimately did at the cost of a substantially shorter strike.

TWA insists that its firm position resulted in establishing once and for all its right to eliminate navigators from its international flights, and thereby averted later strikes on the part not only of the navigators but of radio operators as well. This contention strikes us as pure speculation, without any substantial support in the record. The 1952 collective bargaining agreement had already established TWA's right to eliminate navigators; the 1953 strike was obviously a failure from the start, as the settlement agreement

16694

acknowledged; and we cannot see that the unnecessary prolongation of the strike contributed anything to future labor peace.

In summary, we find that a more communicative attitude on the part of TWA would have appreciably reduced the likelihood of a strike; that a less intransigent attitude after the strike had begun would undoubtedly have greatly reduced its length without requiring any sacrifice of principles; and that the carrier's failure to seek damages from the union was inconsistent with its own professed justification for its rigid attitude during the strike. However, in view of the strike's illegality and lack of justification on the union's part, and the substantial possibility that some strike would have occurred even if the carrier had acted more wisely, we do not feel justified in wholly disallowing the carrier's strike losses.

Considering all of the foregoing factors together, it is our judgment that the examiner satisfactorily resolved the issue by attributing two-thirds of the strike losses to failures of honest, economical, and efficient management on the part of the carrier. Accordingly, $669,000 out of TWA's total 1953 strike loss of $1,003,000 will be disallowed under the statutory test.

16695

Other suggested grounds for disallowance. Having determined that none of TWA's 1946 strike losses and only a portion of its 1953 strike losses should be disallowed under the test of honest, economical, and efficient management, we must next determine whether the carrier's remaining strike losses should be disallowed on any other ground. For, if they should, it would become unnecessary to pass upon the difficult question posed by the court's

remand of whether the strike losses should be assigned to the break-even element of TWA's rate as an expense or to the return element as a risk of doing business. Bureau Counsel argues that the losses should be disallowed on the dual ground that (1) the occurrence of strikes does not contribute to the maintenance and continued development of air transportation for the purposes set forth in section 406(b) of the Act, and (2) the strikes here disenabled TWA from performing the only services for which the Board is empowered to provide compensation under section 406. The examiner rejected this contention.

Although the primary basis for the Board's prior refusal to recognize TWA's strike losses was its conclusion that as a matter of policy it should not attempt to assess strike fault or to intervene in labor disputes on the side of either management or labor and that the risk of strike losses should in any event be borne by the carrier's rate of return rather than its break-even need, the Board additionally found that none of the basic purposes for which subsidy is intended would be fulfilled by recognizing strike costs, even where not assigned as a responsibility of management, and that the Board should not provide subsidy for periods when no service

is performed. Upon further consideration of the matter we now reach the opposite conclusion, and find ourselves in agreement with the examiner.

Bureau Counsel points to our consistent policy of disallowing such items as charitable contributions, entertainment expenses, losses on military contracts and other services ineligible for subsidy, and expenses of prosecuting unsuccessful route applications, among others, without regard to considerations of honest, economical, and efficient management, and argues that strike losses should be

disallowed for the same reasons. The examiner, on the other hand, considered strike losses more comparable to losses caused by floods, fires, aircraft groundings, and strikes in other industries which depress airline traffic, all of which we have heretofore allowed in subsidy cases.

While none of these analogies are so close as necessarily to be governing, we find the examiner's analogies more pertinent than Bureau Counsel's. The distinguishing feature of charitable contributions, entertainment expenses, and the like is that they represent activities which consume the funds of the carrier for purposes not contributing to the maintenance and development of a sound certificated air transportation system, undertaken at the initiative of management and completely within its control. The distinguishing feature of the group of analogies cited by the examiner, on the other hand, is that they are all hazards over whose incidence management has substantially no control, encountered in the course of activities which are a necessary part of the carrier's certificated

16697

operations and which do contribute to the maintenance and development of the air transportation system.

Strikes plainly fit more nearly into the latter category than the former. They are not undertaken on management initiative, but on the initiative of employee groups who are seeking to force management to grant wage and other demands which management deems it in the best interest of the carrier to deny. No airline of any size can be run without large groups of employees, yet the hiring of employees obviously carries with it the risk that they will some day go out on strike. To be sure, since labor relations are an aspect of human relations, management has much greater power to prevent or at least to minimize the occurrence of strikes than it does in the case of floods, aircraft groundings, and other natural and mechanical

hazards. We are not, however, prepared to assert that management has it within its power to avoid strike losses completely—particularly when it is remembered that we are now considering only strikes which are not directly caused or prolonged by any failure of honest, economical, and efficient management.

Once strikes are seen as hazards encountered, rather than as activities undertaken, on management's initiative, the argument on this point loses its force. Obviously strikes do not contribute to the maintenance and development of air transportation, any more than do floods, fires, earthquakes, aircraft groundings, or strikes in other industries; yet losses from all

16698

of these latter hazards have been held to justify increases in mail pay.[12] The analogy of aircraft grounding losses is particularly instructive. When in the *Big Four* case[13] the Board decided to allow grounding losses for subsidy computation purposes, it did not suggest that aircraft groundings themselves contributed to the development of air transportation. It found, rather, that such groundings were an inescapable hazard connected with the introduction of new aircraft types; that the development of air transportation required that carriers prudently but expeditiously introduce such new aircraft types; and that a rule of subsidy rate-making which might have a tendency to deter carriers from introducing new aircraft types

12 *Transatlantic Final Mail Rate Case*, 19 C.A.B. 464, 480 (1954) (TWA's own flood losses); *Wien Alaska Airlines, Mail Rates*, 16 C.A.B. 237, 242 (1952) (fire losses in excess of insurance recovery); *Kodiak Airways, Mail Rates*, Orders E-20637, 20690, 20694, and 20733, April 1, 14, and 24, 1964 (earthquake); *American Air, et al., Mail Rates*, 10 C.A.B. 341, 343-7 (1949) (aircraft groundings); *Trans-Pacific Airlines, Mail Rates*, Order E-12371, April 16, 1958, made final in 26 C.A.B. 703 (1958), and see Orders E-14106, June 25, 1959; E-15330, June 6, 1960; and E-16609, April 4, 1961 (restoration of Aloha and Hawaiian to subsidy status during sugar strike).

13 *American Air, et al., supra*, 10 C.A.B. at 343-7.

would therefore be contrary to the objectives of section 406. The Board therefore allowed losses caused by such aircraft groundings to be capitalized and amortized out of subsidy over a period related to the expected life of the aircraft types themselves.

Here, TWA obviously could not have operated at all without employing pilots, and it could not have operated its international routes during the period in question without employing navigators. Moreover, as the examiner's description of the background events makes clear, the 1946

16699

pilot strike was directly related to the introduction of new four-engine aircraft types into airline service in the postwar period. Similarly, the 1953 navigator strike grew directly out of the development of ground navigation aids in Europe and elsewhere, which gradually made the further employment of navigators unnecessary. Both the introduction of new aircraft types and the spread of ground navigation aids were highly desirable developments in our domestic and international air transportation system. These developments carried with them, however, the risk of just such labor unrest and ensuing strikes as in fact occurred. Accordingly, we find that TWA's strike losses, to the extent we have found them not attributable to any lack of honest, economical, and efficient management, were caused by a hazard integrally related to the development of air transportation, and hence should not be disallowed for subsidy purposes on the basis here suggested by bureau counsel.

The second argument pressed on us is that to make allowance for TWA's strike losses in computing its subsidy mail pay would amount to granting it subsidy for periods during which no mail service was in fact being performed. The court's decision in the AOA case does not specifically dispose of this argument; nonetheless, in

view of the outcome of that case, we must at least treat this argument as suspect.[14]

16700

It seems to us, on reconsideration, that a refusal to recognize strike losses on the latter ground would require that we take a "keyhole view" of the carrier's operations—a view which the Board has frequently refused to take in other contexts.[15] We are here fixing TWA's international mail pay, not for the 38 days during which its operations were impaired or halted by strikes, but for a period of nearly 8 years, during almost all of which it was duly performing certificated passenger, cargo, and mail service.

To be sure, since Congress chose to tie subsidy to the carriage of mail, it may well be that if a strike resulted in a carrier's permanent cessation of its certificated mail service we would be without authority to award it subsidy for any period subsequent to the actual date of termination of such service.[16] But that is not this case, for TWA went on playing an important role in the development of air transportation despite these strikes. As the *AOA* decision emphasizes, the need provision of section 406 looks not so much to the immediate service being performed as to the development of a sound air transportation system capable

14 These, and other, alternate grounds suggested by bureau counsel for reaffirming the Board's earlier action were all in fact relied on by the Board previously, were discussed in the relevant orders, were pointed out to the court by Board counsel as independent justifications for the Board's actions, and were specifically mentioned by the court in the early part of its opinion. Some of the alternate grounds were discussed further in the court's opinion, while others were not; but there certainly is no basis for any assumption that the court misunderstood or ignored them.

15 See, *e.g.*, *Braniff Airways, Mail Rates*, 11 C.A.B. 431, 434 (1950); *Western-Inland, Mail Rates*, 14 C.A.B. 201, 249-51 (1950); *Capital Airlines, Mail Rates*, 14 C.A.B. 623, 625, 626 n. 9 (1951).

16 Compare *Florida Airways, Mail Rates*, 14 C.A.B. 1, 2-5 (1950).

of performing services in the future. The fact here is that TWA came out of each of these periods of interrupted service with fewer funds, therefore with *prima facie* less ability to continue the development of air transportation, and thus with a correspondingly greater need for subsidy. If the carrier is reimbursed by subsidy for its strike losses, therefore, this added subsidy will relate to the carriage of mail and the performance of certificated service *after* the respective strikes, and not during them.

16701

Coverage of TWA's strike losses—break-even need or rate of return—international phase. There remains to be determined what form of provision should be made for the strike losses. Here, as elsewhere, the parties are in diametric disagreement. TWA insists that the *AOA* decision requires the inclusion of its strike losses in its break-even need, while bureau counsel insists that there is nothing in that decision to keep us from adopting slightly more detailed and explicit findings and then proceeding to reaffirm the Board's earlier stand that the risk of strike losses is properly assignable to the carrier's rate of return. The examiner found that the strike losses should be included in break-even need on the ground that the *AOA* decision compelled such treatment. Although our own reappraisal of this issue leads us to the conclusion that the strike losses should be recognized in computing TWA's break-even need, our determination does not rest on the belief that such treatment is required by the *AOA* decision.

It is clear that with respect to rates being fixed for a future period the court unreservedly approved the Board's refusal to project and make provision for possible future strike losses. As to past periods, the court equally strongly emphasized that the Board must take into account the

facts of the carrier's operations as they actually occurred. However, even though some of the language of the court's opinion standing alone might suggest that where a strike has taken place during an open-rate period the carrier's mail pay for that period must include direct break-even reimbursement for the strike losses unless they are disqualified under the standard of honest, economical, and efficient management, the opinion as a whole

16702

convinces us that the court intended no such result. As we read that opinion the court left the way open for an ultimate finding that strike losses are covered by a carrier's rate of return, provided only that any such finding must be based upon the particular facts relating to the operations and rate of return of the individual carrier suffering the strike. Thus, we see the question before us solely as one of whether as a matter of discretion and sound rate-making policy, the losses should be treated one way or the other, and our determination to include the losses in break-even need rests entirely on our judgment that this is the more desirable course under the facts of the present case.

The principal reason put forward for assigning TWA's risk of strike losses to the return element of its subsidy need is that this would be in accordance with the general policy laid down by the Board in the *Braniff* case in 1948, to the effect that all abnormal risks which are neither predictable nor measurable should be met out of the rate of return on investment.[17] However, since the announcement of this general policy 16 years ago, there seems to

---

17 *Braniff Airways, Mail Rates*, 9 C.A.B. 607, 616-7 (1948).

have been no case in which the Board has applied it except in the earlier orders in the present case.[18]

The original *Braniff* case held that losses caused by aircraft groundings should be absorbed by the rate of return; but this specific application of

16703

the supposed general policy was reversed in the *Big Four* case, where the Board held that grounding losses should be met out of the break-even element over a period of years.[19] And in an earlier phase of this very case, the Board held the *Braniff* policy inapplicable to TWA's flood losses.[20] It is true that the Board specified this as an exception to the general policy, which it reaffirmed, and gave as its reason for treating flood losses differently from strike losses that flood losses might bankrupt a carrier, whereas there appeared to be no possibility that strike losses might do so. The fact was, however, that the flood loss recognized for TWA was less than a third of the strike losses we are now recognizing; and it seems to us on reconsideration that in the case of most carriers—certainly in the case of so large a carrier as TWA, whose equipment and facilities are widely distributed and not exposed to any single natural disaster—the likelihood of being crippled by strike losses is far greater than the likelihood of being crippled by losses caused by floods or other similar catastrophies. Similarly, the reason given earlier for treating grounding losses differently than strike losses—that grounding losses were "developmental" while strike

18 In *National Airlines, Mail Rates*, 22 C.A.B. 524, 529 (1955) which is cited by Bureau Counsel, the Board did disallow the carrier's strike losses, but an inspection of the opinion there shows that the disallowance was based on the policy considerations later disapproved by the court in the *AOA* case, rather than on the grounds that the losses should be met out of the carrier's rate of return.

19 *American Air. et al., Mail Rates*, 10 C.A.B. 341, 343-7 (1949).

20 *Transatlantic Final Mail Rate Case*, 10 C.A.B. 464, 480 (1954).

losses were not—now seems to us lacking in substance for reasons previously herein discussed.

In other cases, the Board has made provision in the break-even element rather than the return element for losses caused by fire and by earthquake;

16704

and even provided temporary subsidy for the two Hawaiian interisland carriers, then on a service rate, when their traffic drastically declined because of the 1958 Hawaiian sugar strike.[21] Bureau counsel attempts diligently to distinguish each of these cases from the present one, and in truth some differences do exist, but they do not seem to have any relevance to the expressed rationale of the *Braniff* doctrine. Accordingly, while the policy enunciated in *Braniff* remains in effect insofar as future-period mail-rate computations are concerned, we are constrained to find that it is not being and has not been followed in past-period computations.

We find nothing elsewhere that would require or warrant a refusal to include as a cost in computing TWA's break-even need the strike losses actually incurred by the carrier in the exercise of honest, economical, and efficient management. Here we are fixing a past period rate for TWA's international operations for a period commencing on the date the carrier first inaugurated international services in 1946 and continuing for the eight succeeding years through 1953. Thus, we are faced with the problem that would be encountered in fixing a future rate were strike losses to be taken account of other than through the rate of return, of attempting to forecast costs that are neither predictable nor capable of accurate measurement, for here the amount of the strike losses are known. Nor do we have a situation in which a carrier on a closed rate that was set prospectively suffers a strike and reopens its rate seeking direct

21 See cases cited in note 12, *supra*.

reimbursement through break-even need of its strike losses occurring after the date of reopening (thereby raising the question of possible double provision for the strike

16705

losses), since the rate being fixed for TWA covers its international operations from their inception. Similarly, the length of the open-rate period here involved minimizes the risk of double compensation that might be urged as a basis for refusing to compensate directly for strike losses occurring in a short open-rate period that is followed by a closed period in which future rates have already been established.[22]

Certainly a justification for a rate-of-return treatment, even in the case of past-period rates, might be found in the incentive to avoid unnecessary strike losses which a policy of assigning such losses to the rate of return would give the carrier. However, this treatment could not have had any effect on TWA's labor relations prior to its 1946 strike, in view of the fact that the possibility of such treatment was not made known to the carrier until 1949.[23] (Even the *Braniff* case, which enunciated the general policy from which this treatment of strike losses might have been deduced, was not decided until 1948.)

TWA's 1953 strike presents a different picture, since the Board had by then already announced the policy of assigning strike losses to the rate of return, albeit perhaps not in a form designed to have the maximum impact on the carrier. However, we cannot very well treat the 1953 strike one way and the 1946 strike another unless we are prepared to divide the period

---

22 We express no opinion on the treatment that should be accorded strike-losses in the two latter types of situations.

23 The possibility of this treatment first appeared in Order E-2731 in which the Board directed AOA to show cause why it should not disallow that carrier's strike losses.

under review into two parts and fix a separate rate of return for each, something we certainly do not propose to do at the present stage of this excessively prolonged case. Since the losses from the 1946 strike are substantially greater than the recognized losses from the 1953 strike, the common-sense solution is to apply the treatment appropriate to the 1946 strike to the entire period.

Bureau Counsel urges that TWA grew and prospered during the period in question and thereafter, and consequently cannot demonstrate any need for additional subsidy to compensate it for its strike losses, in order to enable it to maintain and continue the development of air transportation. Clearly, the need of the carrier is the central touchstone for all subsidy determinations. However, it does not follow from this that we must or should disallow the cost of the strikes on such a basis.

Carried to its logical conclusion, this argument would require us to determine the allowance or disallowance of various items for subsidy computation purposes, not as at present on the basis of considerations peculiar to each individual item, but on the basis of a broad qualitative appraisal of the carrier's achievements in the field of air transportation during the period under review. While this position has a certain surface plausibility, and while there is some language in the court's *AOA* opinion which might appear to support such a simplified test, we are convinced that it would be impractical to determine mail rates in this way. It is undoubtedly true that TWA grew dramatically during the period in question, in terms of passengers, property, and mail carried, revenues earned, capital invested, and in numerous other

16707

respects. But if this were a sufficient basis to disallow TWA's strike losses in computing its final subsidy mail rate, it could equally serve as the basis for disallowing any other item, regardless of merit.[24]

In fixing subsidies we are constantly required to rule on the includability or excludability of items which represent only a very small fraction of a percent of the carrier's revenues or expenditures for a particular period. Neither we nor anyone else is wise enough to know whether the allowance or disallowance of an item would spell success or failure for a carrier with an operating budget of tens of millions per year. Indeed, when dealing with a carrier of the size and financial strength of TWA, it would hardly be more than the merest speculation to assert that even a million-dollar difference in subsidy would mark the difference between the carrier's ability and its inability to fulfill the purposes of the statute.

Thus it is not a matter of choice but of absolute necessity that we make our subsidy determinations on an item-by-item basis; and we think it is plain from a reading of other parts of the *AOA* decision that we are statutorily required to do so. Accordingly, while a finding that a particular loss has disabled or is about to disable a carrier from carrying out

16708

its appointed role in the development of air transportation may well serve as the basis for a compensatory increase in

---

24 TWA points out, moreover, that it actually received the subsidies in question at the time under a succession of temporary rate orders, and thus had the use of the money while it was growing and developing in the manner Bureau Counsel describes. The latter's argument therefore seems particularly weak as a justification for recapturing subsidies previously paid. Of course TWA has not proved that such a recapture would disable it from continuing to grow and develop hereafter; but the evident impossibility of such proof simply further demonstrates the fallacy of this whole approach.

subsidy,[25] a finding that the carrier has in fact fulfilled its role in the development of air transportation during a past period cannot by itself serve as the basis for disallowing any paricular loss or expense incurred by that carrier.

Moreover, there is a positive factor, applicable to both the 1946 and the 1953 strikes, which supports the conclusion that assignment of these particular strike losses to break-even need rather than to return is the more appropriate treatment here. As we have previously pointed out, both of these strikes were intimately bound up with the advent of particular technological changes in air transportation—the 1946 strike with the introduction of large four-engine aircraft, and the 1953 strike with the establishment of ground navigation aids abroad which made obsolete the employment of navigators. Both of these technological innovations were of great importance and were highly beneficial to the development of air transportation, and it would have been most undesirable for carrier managements in general and TWA's management in particular to have had any artificial incentive to avoid or delay these developments, as might have been the result of knowing that losses from these particular strikes would have to be met out of return on investment. This intimate connection of these two strikes with the onset of desirable technological developments distinguishes them from the ordinary run-of-the-mill strike over wages, working conditions, or the like, which is not connected with

16709

any particular technological development. In our opinion, this consideration materially shifts the balance in favor of

25 See *Trans-Pacific Airlines*, Order E-12371, *supra* note 12, and other cases there cited.

assigning these particular strike losses to TWA's break-even need.

In view of the foregoing, we find that the purposes of section 406 will best be served by making provision for all of TWA's 1946 strike losses, and for so much of its 1953 strike losses as are not required to be disallowed under the statutory test, as part of its international break-even need for the 1946-53 open-rate period.

The international rate of return. The examiner concluded that the seven-percent rate fixed previously in this case was intended to cover the risk of strike losses, and that the return should now be reduced to 6.9 percent to reflect the elimination of this risk as a result of the recognition of the carrier's actual strike losses as part of its break-even need. We agree with the examiner that the rate previously fixed did include the risk of strike losses, and we are convinced that the seven percent previously established would afford TWA a fair return even had we refused to recognize the strike losses in computing the carrier's break-even need. However, it does not follow from this that we must now reduce the previously established rate of return to 6.9 percent, and we have concluded that we should not do so.

While the theory upon which the examiner operated is not spelled out in the initial decision, it is apparent that he took the seven-percent rate previously determined and simply subtracted therefrom the 0.1 percent which was the minimum figure for average annual after-tax strike impact on the airline industry as a whole for the 1946-53 period, as shown by bureau

nsel's exhibits, thus arriving at a net rate of return of 6.9 percent. The Board, of course, has always used a cost of capital approach in fixing rates, and in arriving at a

rate of return has used the traditional public utility rate-making techniques of relying on guides such as debt-equity ratios and applying to them an informed judgment to arrive at a rate of return that will enable the carrier to attract capital and will adequately compensate the investors for their risks. However, the return has never been computed by attempting to identify all individual risks and to assign a precise value to them, and, indeed, it would be totally impractical to attempt to do so.[26] Similarly, it would be impractical and unrealistic to adopt the reverse procedure here.

It is clear beyond all question that the industry-wide risk of strikes in the review period here was only a small fraction of the seven percent rate of return. Although, under the judgments that must be exercised, a proper rate might be 6.9 percent, just as the original rate might have been 7.1, our examination of the record convinces us that the seven percent rate previously set is fair and reasonable, even after the action we are taking herein, and should not be disturbed.

Losses in the offset phase. We now turn to a consideration of the appropriate form of treatment—coverage by the break-even or by the return element—to be accorded TWA's 1946 domestic strike losses. The examiner concluded that domestic strike losses should not be deducted from the eight-percent return allowed the domestic division in determining whether that

16711

division had excess profits to be offset against the international division's subsidy need. We agree, but we cannot adopt the examiner's reasoning.

---

26 The seven-percent rate fixed initially had its origin in earlier cases in which no specific consideration was given to measuring or providing for the risk of strike losses as such.

The examiner observed that TWA was on a closed future-type mail rate during the offset period in question; that the domestic division's rate of return for offset purposes had been set by us at eight percent on the grounds that this was an appropriate future-period rate of return; and that such future-period rates of return are intended to cover all risks of unforeseeable contingencies, including in particular risks of strike losses. At this point, however, the examiner fell into a semantic trap dug by TWA with its insistence that to compute its domestic strike losses and either add them to its domestic revenues or subtract them from its eight-percent return would amount to "penalizing the carrier twice."

As bureau counsel points out, this is a fallacy—essentially, it is the fallacy warned against by Judge Prettyman in the *Western-Inland* case,[27] of treating a carrier's "need" as a gross from which subtractions are made, rather than as the net figure it is. Adding to the carrier's actual revenues a sum representing revenues it would have received under other circumstances has precisely the same effect on the carrier's "need" as subtracting from its actual expenses a sum representing expenses which it would have avoided under other circumstances; if the latter is legitimate, so is the former. If all profits in excess of a specified rate of return are defined as excess

16712

profits, and if that rate of return is required to cover any strike losses which may occur during the period in question, then any strike losses which do in fact occur must be computed and deducted from the specified rate of return, or (what is equivalent) such strike losses must be added to profits and the specified rate of return then

27 *Summerfield v. Civil Aeronautics Board*, 207 F.2d 200, (C.A.D.C. 1953), aff'd sub nom. *Western Air Lines v. Civil Aeronautics Board*, 347 U.S. 67 (1954).

deducted, in order to arrive at a correct figure for excess profits.

The foregoing will seem to suggest that we must now proceed to add $1,130,000 to TWA's excess profits for 1946-53 available for offset. The explanation for our decision not to do this lies in a closer analysis of the nature of the rate of return being allowed TWA for offset purposes. The crux of the matter is that this is actually not a true future-period rate of return at all, but rather a past-period rate of return containing certain exceptional future elements.

The explanation for this seeming paradox lies in the interaction between the earlier *TWA* case and the *Delta-C&S* case.[28] Even though the *TWA* case forbids us to redetermine retroactively the previously fixed final *mail rates* under which TWA's domestic division operated during the offset period, the *Delta-C&S* case positively requires us to redetermine the *need* of that division for the same period, since this is part of that "need of the carrier as a whole" which sets an upper limit to the subsidy it may receive. Since this need is being determined after the fact, the *Western-Inland*,[29] *Delta-C&S*,

and AOA cases all require us to base our determination on the figures from the carrier's operations as they actually occurred, not as they had previously been forecast. Moreover, as we have pointed out before, the only need of a carrier recognized by section 406 is its need under honest, economical, and efficient management; hence we are bound to eliminate from TWA's domestic figures for the offset period those expenses and losses which were not

---

28 *Transcontinental & Western Air* v. *Civil Aeronautics Board*, 336 U.S. 601 (1949); *Delta Air Lines* v. *Summerfield*, 347 U.S. 74 (1954).

29 *Supra*, note 26.

incurred under such management. These are all characteristics of a past-period determination.

The manner of computing excess profits likewise suggests more a past-period than a future-period calculation, in that such excess profits are defined as those in excess of a return on investment computed at precisely a specified rate. In contrast, a future-period rate of return is one expected to be achieved exactly only in a hypothetical "normal" year; the everyday risks of the business are expected to make the actual return fluctuate above and below the prescribed rate, averaging out in the long run but not necessarily over any fixed period. Thus the manner of making the offset computation relieves the carrier of numerous risks ordinarily covered by a future-period rate, just as does an ordinary past-period computation.

All this points to the fact that our determination of TWA's domestic need for offset purposes is essentially a typical past-period determination, comparable in every important respect to our determination of TWA's international need for the same period. Accordingly, the appropriate return element to be allowed is a past-period return element, although as will be seen hereafter the actual rate of return must take into account certain risks not ordinarily included within a past-period rate.

16714

Since TWA's domestic rate of return for offset purposes is thus seen to be a past-period rate, it is no longer a foregone conclusion that strike losses must be met out of this rate of return, as would unquestionably have been the case if this were a true future-period rate of return. The risk of ordinary contingencies having been transferred from the return element to the break-even element, it may well be that the risk of extraordinary contingencies, such as strikes, should likewise be so transferred. The relevant considerations are exactly the same as in an ordinary

past-period situation; principally, whether assignment of the risk of strike losses to the return element will have a net incentive effect tending to reduce the likelihood of strikes while not pushing management in the direction of other uneconomic practices. In this case, a weighing of all considerations—particularly the fact that a policy first announced in 1948-49 could not have helped motivate the carrier's actions in 1946—leads us to conclude that the purposes of section 406 would best be served by assigning the risk of strike losses during the offset period to the break-even element rather than to the return element of TWA's domestic need.

Since the rate of return previously fixed for TWA in the offset phase, like that fixed in the transatlantic phase, was intended to cover the risk of strike losses, the reassignment of such losses to the break-even element requires us to review the carrier's domestic rate of return. We have done this, and have concluded that no change should be made in the return.

In this connection, we wish to note one particular factor which distinguishes this domestic offset rate of return from an ordinary past-period

rate—a factor concerning the risks covered by the offset rate. While the offset rate is not required to cover the risks of ordinary short-run small-scale fluctuations, it is required to cover certain large-scale long-run risks which are not present in the case of an ordinary past-period rate. These exceptional risks arise out of the fact that while the carrier's domestic *need* is being redetermined on a past period basis, its domestic *mail rate* is fixed and not subject to being redetermined. Consequently, if unforeseen contingencies combine to reduce the carrier's domestic profits to the point of eliminating its excess profits altogether, any further losses will be borne directly by its

stockholders, not by subsidy. On the other hand, of course, if it can increase its domestic profits to the point where its excess profits are sufficient to cover completely its international need, then any additional profits beyond that point will no longer go to reduce subsidy but will accrue instead to its stockholders.

A graph of the carrier's domestic profits retained vs. domestic profits earned will thus be characterized by an upward slope broken by a flat plateau, the width of the plateau being measured by the carrier's international need. In such a graph, three zones can be distinguished: (1) a lower zone, in which the carrier's domestic profits are less than its approved domestic rate of return, and in which this earnings deficiency is borne by its stockholders; (2) a middle zone (where TWA actually found itself), in which it has domestic profits in excess of its approved domestic rate of return but not sufficient to cover completely its international need, and in which the return to its stockholders remains constant because small

16716

increases in domestic profits go via offset to reduce international subsidy, while small decreases in domestic profits correspondingly serve to increase international subsidy; and (3) an upper zone, in which its excess profits are sufficient to cover completely its international need, and in which accordingly all further profits accrue to its shareholders.

Here, even though the level of TWA's domestic profits during the offset period put it in the middle zone where the risk of ordinary fluctuations fell on subsidy rather than on its stockholders, it was required to bear the risk that adverse conditions would push it into the lower zone, where its stockholders would once again be bearing the ordinary risks associated with a future period mail rate.

From an investor's point of view, so long as TWA's domestic division earned less than its approved rate of return, the risk of losses fell on the carrier's investors, while on the other hand, these investors were deprived of much of their usual opportunity for compensating profits, since profits above the specified rate would be declared "excess" and used to reduce the carrier's international subsidy.[30]

We have taken the foregoing unusual risks into account in redetermining TWA's domestic rate of return for offset purposes. We have also taken into account the fact—significant because it is basically the actions of the investing community which determined what is a proper rate of return—that

16717

during almost all of the period in question a prospective investor in TWA's securities would undoubtedly have acted on the theory that its domestic division was bearing all the ordinary risks associated with a future-period mail rate, but similarly was in a position to reap the benefits of a closed-rate status.[31] In our judgment, this unusual distribution of risks justifies a rate of return more on the order of an ordinary future-period rate than of an ordinary past-period rate; and the somewhat unfavorable aspect of this risk distribution from the investor's point of view compensates for the elimination of the risk of strike losses.

---

30 As against this, of course, it should be noted that TWA's excess profits were computed for the offset period as a whole, so that earnings deficiencies during one part of the period could be and were made up out of profits realized during the balance of the period before any profits for the period as a whole were declared excess.

31 The *Delta-C&S* case, which gave rise to the offset problem and to the unusual distribution of risks associated therewith, was only decided by the Court of Appeals in May 1953, and was affirmed by the Supreme Court in February 1954, after the period of the review was actually over.

16718

The "Deferred" Tax Issue

Section 168 of the Internal Revenue Code of 1954 (formerly section 124A of the Internal Revenue Code of 1939) provides that the cost of new equipment which qualifies as an "emergency facility" may be depreciated for income tax purposes over a period of five years rather than over the longer period normally allowed.[32] In the years 1951-1953 TWA purchased certain equipment for use in its domestic operations which qualified for accelerated depreciation under the law and elected to avail itself of the special tax treatment. The result was that for the years 1951, 1952 and 1953, TWA's actual tax payments were $2,990,123 less than they would have been had the carrier depreciated the equipment on a straight-line basis.[33]

TWA accrued the $2.9 million in a reserve on its books (allocable to its domestic division) on the theory that the amount thus accrued would have to be paid in later years when, for tax purposes, the equipment would be considered as fully depreciated, thereby increasing the carrier's earnings that would be subject to income

---

32 26 U.S.C. 168. Section 124A was enacted in 1950 following the outbreak of hostilities in Korea. The purpose of the section was to encourage the investment of private capital in facilities needed for national defense purposes during the Korean emergency by insuring investors that their investment in the emergency facilities would be fully depreciated for tax purposes by the end of the emergency.

33 As to a given item of property, the effect of using accelerated, rather than straight-line, depreciation is to increase the depreciation in the early years of the life of the property, with a resulting decrease in taxable income, and to decrease the depreciation in the later years of the life of the property, with a resulting increase in taxable income. Under both methods, the total depreciation over the useful life of the particular facility is the same.

16719

tax. TWA claims that the reserve represented a liability, the payment of which was simply deferred until a future day, and, as such, should be recognized as an expense in determining the excess earnings of the domestic division that are available for offset.

The examiner agreed with TWA. His decision rested essentially on his conclusion that, as held by the Board in the *General Passenger Fare Investigation*,[34] the normalization of taxes through a deferred tax reserve is necessary to carry out the intent of Congress in authorizing accelerated depreciation to grant taxpayers "what amounts to an interest-free loan in the earlier years of the service life of assets to be repaid in later years" and that, even assuming a valid distinction can be drawn between the treatment that should be accorded such reserves in subsidy mail rate cases and commercial mail rate cases, such distinction should not affect the decision here, since TWA's domestic division was on a closed future service rate and the Board is only screening the operating results of that division for offset purposes. We reach the opposite conclusion and find that the accruals in the deferred tax reserve should be treated as revenues of the domestic division that are available for offset against the need of the international division.

There is no dispute as to the basic facts that we deem to be critical in the resolution of the deferred tax issue. Those facts are as follows: (1) That mail rate fixed for TWA for the 1946-1953 review

16720

period fully recognizes as an operating expense the carrier's actual tax liability during those years. (2) TWA's

34 32 C.A.B. 291 (1960).

total mail pay under that rate is in excess of $49,000,000 and includes a subsidy element which exceeds by many times the $2.9 million in the deferred tax reserve. (3) TWA is, and at all times since January 1, 1954, has been, entirely self-sufficient both domestically and internationally, receiving mail pay only under compensatory mail rates containing no element of subsidy. (4) The carrier has had the continuing right granted by section 406 to reopen its compensatory service rates were it at any time to deem them inadequate.

In the light of those undisputed facts, the question before us, in the final analysis, is whether this Board, having met TWA's "need" during the period it required subsidy assistance and having established a rate that would fairly compensate it for the carriage of mail in the future, should additionally underwrite with subsidy as an expense of the past period $2.9 million the carrier accrued to meet future tax payments, which, to the extent that they are paid, will be paid at a time when TWA has no need for subsidy. We conclude that TWA is not entitled to this additional subsidy.

It is clear that under section 406 of the Act, as interpreted by the Board and the courts, TWA's tax claim cannot be allowed for subsidy purposes. The Board in fixing TWA's mail rate for the 1946-1953 period has recognized as an expense the full amount of the carrier's actual tax liability for the period. The allowance for taxes is not limited to taxes attributable to profits reflecting just compensation for the transportation of the mails, but covers taxes on the carrier's total profits, including profits stemming from subsidy in an amount sufficient to meet the carrier's losses from its commercial services and yield it a reasonable return on its investment allocable to those commercial services.

That tax allowance is in accordance with the "actual tax" policy adopted by the Board in *Western-Inland Mail Rates*,[35] and followed uniformly by it since that time in fixing past period subsidy rates.[36] The actual tax policy is consistent with the basic purpose of a tax allowance which is to assure that by treating taxes like any other operating expense the carrier will in fact receive the rate of return to which it has been found entitled. Further, the tax allowance made by the Board accords with the court's ruling in the *Western* case, *supra*, that in fixing past period subsidy rates, as in this case, the Board must act on the basis of "known facts," not hypothesis. The "known facts" are that TWA in the 1946-1953 review period was not liable for and did not pay out in taxes any part of the $2.9 million in the reserve.[37]

The service mail rates for both the domestic and international decisions of TWA that have been in effect since January 1, 1954, provided an appropriate allowance for taxes, computed on the constructive basis

---

35 14 C.A.B. 201, 251-255 (1950).

36 The Board's actual tax policy was challenged by Western in its appeal from the *Western-Inland Mail Rate Case* and was affirmed by the Court of Appeals. *Western Air Lines* v. *Civil Aeronautics Board*, 207 F. 2d 200 (1953), aff'd 347 U.S. 67 (1954).

37 We find no merit in TWA's contention, which the examiner accepted that the Board's tax policy is one of "actual tax liability" and not "actual tax payment" and that, accordingly, recognition of the deferred tax reserve as an expense would be consistent with that policy. Characterized accurately, the Board's policy of allowing for actual taxes is a tax return method of computing the recognizable tax allowance.

"By the tax return method in past period mail rate cases we mean the technique of providing for a carrier's liability for income taxes on the basis of reliable evidence regarding the carrier's tax returns filed with the Bureau of Internal Revenue, together with any adjustments made by the Bureau as of the most recent practicable date prior to the Board's order establishing final mail rates." *Western-Inland Mail Rate Case*, *supra*, p. 251, fn. 23.

16722

normally followed in fixing future period rates.[38] At no time has TWA challenged the sufficiency of its service rates. Thus, TWA has received just and reasonable mail compensation, including an appropriate allowance for taxes, for its services since January 1, 1954, and, being entirely self-sufficient, can establish no "need" within the meaning of section 406 of the Act for the amount accrued in the deferred tax reserve in 1951-1953 for any period subsequent to 1953. Should the carrier at some future date deem its service mail rates to be inadequate, it has the right to file a petition reopening those rates.

Against this background, recognition as an expense of the amount accrued by TWA to provide for the higher taxes the carrier expected to pay at some future date would be inconsistent with the unchallenged finding that TWA is now self-sufficient, and would be in direct conflict with the holding of the courts that the subsidy paid to a carrier by the Board under the provisions of section 406 of the Act cannot exceed the carrier's "need." *Western Air Lines* v. *Civil Aeronautics Board, supra.*[39]

The question remains whether section 168 requires that the Board recognize the amounts accrued in the tax reserve as an expense. We are convinced that it does not.

16723

Section 168 did not purport to, nor did it, result in either an amendment or a *pro tanto* repeal of section 406 of the Act. The problem here is not whether, as TWA

38 That allowance, of course, was limited, as it is in all service mail rates, to taxes allocable to the carrier's mail service.

39 Also, recognition of the deferred tax reserve could hardly be reconciled with the court's decision in *Transcontinental & Western Air* v. *Civil Aeronautics Board, supra*, which held that the Board cannot fix a new mail rate for a carrier and make it retroactive for a period in which a final mail rate previously fixed by the Board was in effect and unchallenged by the initation of a mail rate proceeding.

contends, "special" legislation governs that which is "general." The problem is one of reconciling the provisions of the tax statute and those of section 406 of the Act.

The underlying purpose of section 168 was to encourage the investment of private capital in facilities needed for national defense purposes during the Korean conflict by insuring that the cost of emergency facilities could, at the taxpayer's election, be amortized over the useful life of those facilities, which was deemed to be five years. Section 168 was available to all taxpayers—those engaged in regulated and unregulated alike—and there is not the slightest indication that Congress contemplated or intended that the tax statute override all previously enacted regulatory legislation, in general, or the Federal Aviation Act, in particular.

In the recent decision in *Panhandle Eastern Pipe Line Co.* v. *Federal Power Comm'n.*,[39a] the court said:

> "We now consider briefly the policy underlying §167 of the tax statute. Nothing in the language or legislative history indicates that Congress considered its regulatory consequences. Thus, to infer that the statute materially altered fundamental principles of rate regulation—which require rates to reflect actual cost of capital—it must clearly appear that Congress intended to benefit producers to the exclusion of consumers."

It is reasonable to assume that if Congress did not intend its action in allowing accelerated depreciation for income tax purposes to alter fundamental principles of commercial rate regulation, it can even less be presumed to have

16724

intended or contemplated that its action would override or nullify the specific provisions of section 406 governing

39a 316 F. 2d 659, 662 (1963).

the payment of subsidy to air carriers, with the effect of requiring the Board to underwrite with subsidy deferrals made in anticipation of future tax payments which the carrier would be required to make, if at all, only at a time when it no longer has a "need" entitling it to subsidy.

The court's statement in the *Panhandle* case was, of course, made with reference to accelerated depreciation under section 167 of the Internal Revenue Code. However, we have discovered nothing in the legislative history of section 168 that would make it less applicable to that section.

We recognize that unlike section 167, which was designed to strengthen the economy generally, section 168 reflects national defense considerations. But so does the Federal Aviation Act. No useful purpose would be served by speculating as to whether section 168 or the subsidy provisions of section 406 should be deemed to have the broader national defense objectives. It will suffice to state that both are responsive to the same interest, and it is difficult to conceive of a statute that gives broader recognition to national defense considerations than the provisions of section 406 which authorize direct subsidy mail payments by the Government in an amount sufficient to make up all losses incurred by an air carrier under honest, economical and efficient management to the extent this is required to enable such carrier "to maintain and continue the development of air transportation to the extent and of the character and the quality required for * * * the national defense."

16725

Further, if TWA does not fully realize the benefits of rapid amortization, this will be due to the fact that it required subsidy in the past period for which the rates are being fixed. The Board is not here determining that tax savings from rapid amortization or depreciation should flow through to the consumer, and had TWA been in a subsidy-free status for the years 1951-1953 it would have

received the full benefits of section 168.[40] All that the Board is doing is declining to provide subsidy for the past period in excess of the carrier's established need to meet an anticipated tax liability to become due at a time when the carrier has no need for subsidy.

What has been said is applicable to TWA's contention that the carrier having, in good faith, obtained certificates of necessity in order to qualify for the advantages of section 168, it would be unconscionable now to "penalize" it for availing itself of the provision by treating the accruals for deferred taxes as earnings available for offset, thereby reducing the subsidy it would have received had it not elected to utilize accelerated amortization. Just as it is clear that had TWA not required subsidy in the open period it would have realized all possible benefits of section 168, it is similarly clear that had TWA not elected to avail itself of accelerated amortization its actual taxes paid under straight line depreciation would have been recognized by the Board in determining the amount of its domestic earnings that were available for offset in

computing its need. However, the present result, unfortunate though it may be from the carrier's standpoint, flows from the actualities of the situation and not from any deprivation by the Board.[41]

---

40 Indeed, but for the issuance, subsequent to the time TWA elected to avail itself of the right to utilize accelerated amortization, of the court's decision in *Delta* requiring the Board to base subsidy on the need of the carrier as a whole, TWA would have realized the full benefits of section 168 notwithstanding its subsidy status.

41 TWA's contention that its action in accruing for taxes deferred under section 168 represents sound accounting practice does not require extended comment. The short answer is that the Board is not here concerned with accounting, but with rate-making, and even full acceptance of the soundness of the carrier's treatment of the deferrals from an accounting standpoint would not warrant recognition of the deferrals as an expense of the past period in determining its mail rate.

In this connection, one additional matter should be noted. TWA paid income taxes in 1959 (the first year in which the accelerated depreciation could have resulted in higher taxes), and in 1960, but those taxes were refunded under the carry-back provisions of the Internal Revenue Code as a result of substantial losses suffered by the carrier in 1961 and 1962. Although TWA's current financial picture makes it reasonable to assume that the carrier will ultimately "use up" all of the tax credits accumulated in past loss years, the fact remains that as a practical matter TWA, at the time the case was submitted for decision, still had not paid out in taxes any part of the $2.9 million in the reserve and accordingly has had the continued use of the amounts in reserve.

The preceding discussion is dispositive of TWA's arguments based on the Board's decision in the *General Passenger Fare Investigation* which recognized the accruals to a deferred tax reserve as an expense. In that case, the Board was establishing standards for determining the reasonableness of air carrier passenger fares. It did not have before it the question of the treatment that should be accorded accelerated amortization or depreciation

16727

in fixing subsidy mail rates, and did not, of course, give any consideration to the matter. Subsequently, in the *Reopened Pan American Mail Rate Case* (Order E-18018, February 13, 1962), the Board, in recognition of the differences between commercial and subsidy ratemaking, refused to recognize accruals to a deferred tax reserve under section 167 as a current expense in fixing subsidy mail rates. The Board there stated that "notwithstanding the fact that such deferred taxes would be allowable in computing the level of passenger fares," it would not treat them as an expense, since "recognition of these deferred tax

accruals would be inconsistent with our policy of underwriting no more than the carrier's actual tax payment for subsidy rate purposes * * *." For the reasons heretofore set forth, we are convinced that the Board's action in the latter proceeding was correct, and should be followed as to accruals under section 168.

We find no merit in the contention that even if a valid distinction can be drawn between the treatment that should be accorded deferred tax reserves in fixing subsidy mail rates and other rates, there is no justification for such treatment in the present situation for the reason that TWA's domestic division is on a closed service rate and the Board is not reexamining or refixing that rate but is only screening the results of the division's operations for offset purposes. In an earlier phase of this case the Board rejected the argument that in determining the availability of domestic income for offset purposes it could not screen the results of domestic division operations but must accept the carrier's reported results.

Reopened Transatlantic Final Mail Rate Case, 23 C.A.B. 307, 325. We agree with the Board's earlier statements rejecting that argument, and find them dispositive of the present contention. The short of the matter is that when one division of a carrier is on subsidy the entire carrier must be so considered. Any other conclusion would defeat the court's ruling in *Delta, supra,* that under the Act a carrier's subsidy entitlement is limited to the need of the carrier as a whole.

Tax credit provision. One final matter requires comment. A tax credit of $1,033,000 will accrue to the carrier, at current tax rates, as a result of the payback that will be required under our decision representing over-

payment of temporary mail pay. In accordance with customary practice the amount the carrier will be required to refund to the government will reflect that credit. However, we cannot overlook the carrier's present tax situation. As a result of losses in 1961, the carrier has substantial loss-carry-forward credits which it may apply to future taxes under section 172 of the Internal Revenue Code. There is no indication that TWA will fail to realize sufficient taxable income during the generous carry-forward period to exhaust those credits plus the still further tax credits created by this decision. We, therefore, shall provide for refund of the full tax credit in computing TWA's mail pay. However, in fairness to the carrier and in accordance with our actual tax policy, we shall make the final mail pay subject to appropriate adjustment at the end of the statutory period under section 172 to reflect

16729

its actual use of the tax credit generated by this decision, should the credit or any part thereof not be used up by that time.

Conclusion

On the basis of the foregoing findings and conclusions, and subject to the provision hereinafter stated, we find that the fair and reasonable rate of compensation to be paid under section 406 of the Act to Trans World Airlines, Inc., for the period February 5, 1946, through December 31, 1953, for the transportation of mail by aircraft, the facilities used and useful therefor, and the services connected therewith, between the points between which it was then authorized to carry mail by its certificates of public convenience and necessity, other than certificates authorizing (1) interstate air transportation as defined in the Federal Aviation Act, and (2) air transportation between the

United States and terminal points in Canada, is the sum of $48,633,000.[42]

The compensation provided by the rate fixed herein shall be in lieu of and not in addition to the mail compensation heretofore received pursuant to temporary rate orders by Trans World Airlines, Inc., for the services and period covered hereby.

The rate fixed herein is subject to further adjustment to reflect properly such actual tax credits as may ultimately accrue to the carrier as a result of the payback required hereby.

16730

We have considered all the contentions of the parties not specifically referred to herein, and have found them to be without substantial merit. Except as otherwise indicated, all applications, petitions, and motions herein will be denied.

An appropriate order will be entered.

Member Minetti filed the attached concurring and dissenting statement in which Vice Chairman Murphy concurs. Members Gurney and Gillilland filed the attached joint concurring and dissenting statement. Member Gillilland also filed a further dissenting statement.

---

42 The specific computations are set forth in Appendices B-F, attached hereto. The examiner inadvertently listed the total losses stemming from the navigators' strike as $1,033,000 rather than the correct figure of $1,003,000. The attached computations are based on the $1,003,000 figure.

16731

MINETTI, MEMBER, WITH WHOM VICE CHAIRMAN MURPHY CONCURS, CONCURRING AND DISSENTING:

I concur with the majority's disposition of the "deferred" tax issue in accordance with the Board's historic actual tax policy. I agree, also, that the losses stemming from the last eight days of the 1953 navigators' strike should be disallowed. I disagree with the decision to recognize the losses stemming from the 1946 pilots' strike and the first four days of the 1953 navigators' strike. I would disallow the carrier's strike losses in their entirety. Those losses and, indeed, the risk of such losses are properly borne by the carrier as part of the rate of return on investment allowed in the Board's subsidy computations and reflected in the Board's determination of subsidy. Such was the previous unanimous holding of this Board and I am not persuaded that these circumstances now warrant a different view. (19 C.A.B. 464, 466-469 (1954); reaffirmed 21 C.A.B. 484 (1955).) Had the majority now disallowed the strike losses in their entirety, there would be a reduction in the carrier's subsidy, and savings to the public as a result, in excess of $2,250,000. Considerations of the elements of return on investment aside, it is clear that all such losses must be disallowed in their entirety as they were not incurred nor would they have continued "under honest, economical and efficient management." The technique of the majority in assessing the carrier's conduct against the measure thus literally provided in section 406 of the Act is not persuasive.

Finding as I do that strike losses are historically compensated for by the return element, I reach the issues regarding the carrier's "honest,

economical and efficient" management, or lack thereof, as other grounds for their disallowance contrary to the subtle rationalizations indulged in by the majority.

The 1946 Pilot Strike. As World War II drew to a close there became available to the U. S. airlines for the first time four-engine transport aircraft of the type that had been used by the military services during the war. When these new aircraft were introduced, there were, of course, no agreements in effect covering pilots' pay for the four-engine equipment. TWA's 1945-46 dispute with the pilots was concerned basically with wage rates for the new four-engine aircraft.

At the outset of negotiations in 1945, TWA, in accordance with the long established practice in the airline industry, undertook to bargain with its pilots on an individual basis. Those negotiations went on for a period of time without resolution of the dispute. In the meantime, the major U. S. airlines in the fall of 1945 had formed the Airlines Negotiating Committee (ANC), for the specific purpose of negotiating wages on an industry-wide basis for the pilots of four-engine aircraft. Following the organization of ANC, TWA abruptly discontinued its individual negotiations with its pilots and turned the negotiations over to ANC.

That change had an immediate and unsettling effect. The union reacted violently and took the position that TWA's use of ANC as its bargaining agent was illegal under the Railway Labor Act. The union was further of the view that the change in the negotiations indicated

16733

that the major airlines as a group were using the TWA situation as a test case for the establishment of pilot wage rates on four-engine aircraft throughout the industry.

After the initial negotiations between the pilots and TWA failed to produce an agreement, efforts were made to settle the dispute through the machinery provided by the Railway Labor Act. The history of those efforts is set forth in detail in the initial decision and will not be repeated here. It should be pointed out, however, that the basic issue of wages became intertwined with, and to a substantial degree overshadowed by, the controversy as to whether negotiations between TWA's pilots and the company should be conducted on TWA's side by the company itself or by ANC as its agent, and whether the TWA dispute should be handled as a separate matter or considered in the context of an over-all settlement involving all of the airline companies and their respective pilot employees. Throughout, TWA remained adamant in its position that negotiations on its behalf should be conducted by ANC, and ANC continued to insist that the pilot wage question of all the companies should be considered concurrently.

Following several months of unsuccessful efforts to settle the dispute under the provisions of the Railway Labor Act, the pilots, in the late spring of 1946, gave notice of their intention to strike the company. The appointment of a Presidential Emergency Board averted a strike at that time and in July 1946 the Emergency Board issued its decision, setting forth its findings on the TWA wage dispute. TWA agreed to accept

16734

the Emergency Board finding but the pilots refused. In October 1946, after more than a year of fruitless negotia-

tions and recourse to various procedures, the pilots finally went out on strike. It was not until after the strike occurred that discussions between the pilots and TWA were resumed with TWA bargaining for itself rather than through ANC. With the assistance of the Mediation Board, an agreement between the pilots and the company was reached in November 1946 and the strike ended.

Under the Act, the Board is empowered to grant subsidy to an air carrier only to the extent that the need for such assistance arises in the exercise of honest, economical, and efficient management. It seems clear to me that where, as here, the Board is asked to underwrite with public funds losses stemming from a dispute between labor and management, the test of economical and efficient management requires, at a minimum, that the carrier must have taken all reasonable steps to avoid the strike with its resulting losses. That, TWA failed to do.

The history of the pilots' dispute leaves no doubt in my mind that TWA's insistence on the use of ANC, far from providing any reasonable expectation of avoiding the strike, was a major factor in producing it. Further, even at that time it should have been obvious to a prudent management faced with a difficult and explosive labor situation that this would be so.

The union insisted that resolution of the dispute be undertaken through individual negotiations between TWA and the pilots rather than

through ANC, the industry-wide bargaining committee. The union's insistence did not represent a demand for the use of a new and novel procedure but only sought the application of the bargaining techniques that were traditional in the airline industry. That this insistence was not unreasonable would appear to be borne out by the

view of the President's Emergency Board that industry-wide bargaining can best be established through mutual agreement of the parties. TWA persisted in its determination to bargain only through ANC, with the result that there ensued months of negotiations which not only proved fruitless, but superimposed on the basic question of wages the controversial and complicating question of industry-wide bargaining.

The majority does not deny that wisdom would have dictated that TWA accede to the union's request for individual negotiations and bargaining over wages on that basis. The determination to recognize the losses rests entirely on the conclusion that even had TWA negotiated on an individual basis the strike would, nonetheless, have occurred and could have been avoided only by the company's yielding to the total wage demands of the pilots. I find no basis in the record for that conclusion. On the contrary, it appears equally, if not more, reasonable to assume that individual negotiations undertaken without the irritating influence of the question of industry-wide bargaining would have resulted in settlement without a strike. Similarly, the terms of the settement finally reached negate any assumption that a resolution of the dispute short

of a strike could only have been achieved through the company's yielding to the wage demands of its pilots. Even were I to reach a different conclusion on that matter, I would, nonetheless, disallow strike losses. The question presented by the statute and which the Board must here resolve is whether TWA's actions in the handling of the dispute met the test of honest, economical, and efficient management. Since they did not, I can find no warrant in the statute for recognizing the strike losses on the speculative assumption that had the carrier, contrary to the

demonstrated facts, acted economically and efficiently, thereby satisfying the requirement of the statute, the losses would, nonetheless, have occurred.

The 1953 Navigators' Strike. I further conclude that TWA was inefficient and uneconomic in its handling of the 1953 navigators' strike from its inception, and that the losses attributable to that strike should be disallowed in their entirety.

The development of ground navigation facilities in the 1940's made it clear that the services of navigators on international flights would at some future date become unnecessary. That development created a serious labor problem, for it confronted the navigators not with a grievance over wages or working conditions, but with the shattering prospect of a loss of their jobs. I do not suggest that TWA or any other carrier should have continued to employ navigators or other personnel whose services, because of technological developments, were no longer required. However, good labor-management relations in such

16737

a situation obviously called for maximum efforts by the company to allay any unnecessary fears of its navigators of early layoffs. TWA made no real efforts in that regard but, on the contrary, throughout the period leading up to and during the strike, adopted a casual attitude which ignored the seriousness and the urgency of the problem and the understandable concern of the navigators. TWA had only to take the navigators into its confidence regarding its plans for their future employment at some time prior to the work stoppage and the substantial possibility of averting a strike altogether might have been realized.

The record shows that in 1952 the carrier requested and received tentative Civil Aeronautics Administration

permission to use ground navigational facilities and to discontinue using navigators on its Paris-Rome flights within Europe. TWA intended to put its plan into effect a year later, but it made no effort to advise the navigators of those plans. The carrier asserts that its reason for not informing the navigators or their union was its desire to effectuate the change in operations with a minimum of confusion and misunderstanding. We do not question the carrier's motives. However, it seems clear to us that it either knew or should have known that the navigators were confused and worried about its plans, and should have foreseen the necessity of communicating and explaining them. Nevertheless, TWA remained silent until June of 1953. By that time the navigators were not only aroused but were justifiably fearful that this was a first step in precipitously removing navigators from all international flights.

16738

A few days before the strike was called, TWA scheduled and flew a survey flight from the United States to Europe without a union navigator aboard. That move, which was to determine the feasibility of using ground navigational facilities, was particularly ill-timed. The navigators' job-anxiety reached fever pitch. Their obvious concern remained unabated with TWA's continuing inaction. Finally, the navigators struck. Actually, TWA did not furlough any navigators until 1958, some five years after the strike, and again, it is clear that management, had it made the effort, could have allayed the navigators' fears and probably prevented the strike. Its neglect to do so in these circumstances must be adjudged as uneconomic and inefficient management.

I recognize that the strike was illegally called and that it violated the then current working agreement and the con-

tractual provisions which prohibited strikes until all procedures under the Railway Labor Act were exhausted. However, I am not here concerned with the question of whether TWA could and should have brought suit against the union for its violations of the outstanding agreement. Our task is to determine whether the strike losses should be compensated for through subsidy under the provisions of section 406 of the Act. As I read the statute, the mere fact that the navigators may have acted unlawfully does not relieve the carrier of its obligation to conduct itself in an economical and efficient manner if it is to have its losses recognized for subsidy mail rate purposes. In my view, TWA's management through its

16739

failure to take the steps that I believe a prudent management would have taken permitted the strike to occur when it could have prevented it. Under these circumstances I can find no justification for underwriting any part of the ensuing losses with subsidy.

/s/ G. Joseph Minetti

/s/ Robert T. Murphy

16740

GURNEY AND GILLILLAND, MEMBERS, CONCURRING AND DISSENTING:

We disagree with the Board's decision on the issue of "deferred taxes" and would affirm the Examiner on this point. We would recognize as an expense item the federal income taxes for which TWA became liable during the 1951-1953 review period but which were deferred for later payment under the provisions of section 124A of the Internal Revenue Code of 1939 (now section 168 of the Internal Revenue Code of 1954). Since the Examiner has reviewed the history of this issue and the reasons for his decision so completely, we will not duplicate his effort except to touch upon the highlights of the issue as it has been presented to the Board.

The Examiner's decision conforms to the intent of Congress which in 1950 after the outbreak of hostilities in Korea provided for accelerated depreciation to encourage industries to acquire facilities "certified as necessary to the interest of the national defense during the emergency period." Not every industry or business could take advantage of this tax statute, but only those who were so certified by the appropriate government agency. This certification is not required under section 167 which was first enacted in 1954 as part of the Internal Revenue Code, and which permits any business to accelerate depreciation during the early years following acquisition of equipment, and the two provisions should not be confused. Section 168, with which we are concerned here, is no longer available to newly-acquired facilities and could only be used for facilities acquired prior to 1960, while section 167 is still applicable.

Section 168, however, did not exclude air carriers, on or off subsidy, but extended the benefits to all eligible taxpayers. This provision reads:

> "*Every* person, at his election, shall be entitled to a deduction with respect to the amortization . . . of any emergency facility . . ." (Emphasis supplied.)

The Examiner's decision also conforms to the only federal court decision interpreting section 168, that being *City of Detroit* v. *Federal Power Commission,* 230 F. 2d 810 (1955), cert. den. 352 U.S. 829 (1956), in which the court upheld the Commission's treatment of deferred taxes, stating:

> ". . . that the intent of Congress reflected in Section 124A is not to benefit consumers but rather the taxpayer in order to encourage construction of certain emergency types of facilities."

Although other decisions of this Commission and appeals therefrom may be referred to, those decisions are applicable to the proper rate of return on accumulated reserves for deferred taxes and are not pertinent to the issue here.[1] It is significant, however, that the Interstate Commerce Commission and the North Dakota Commission are the only regulatory bodies which have denied normalization of accelerated amortization.[2]

The majority decision herein fails to recognize that it is departing from its policy enunciated in the *General*

---

1 *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 316 F. 2d 659 (1963), cert. denied 375 U.S. 881 (1963). *Alabama Tennessee Natural Gas Co.*, Opinion No. 417 of the Federal Power Commission (Issued Feb. 3, 1964).

2 The position of the North Dakota Commission as to section 168, however, was rejected in *Re Montana-Dakota Utilities Co.*, 102 N.W. 2d 329 (1960).

Passenger Fare Investigation, 32 C.A.B. 293 (1960), wherein accelerated depreciation of capital assets

taken by air carriers was one of the factors which would be recognized in determining passenger fare levels. The majority attempts to distinguish its treatment of deferred taxes in a fare-level case from that involving a subsidy rate case. The two cases cannot be distinguished, however, in view of the intent and purpose of the statutory scheme.

The fact that national defense is one of the factors which the Board must consider in determining subsidy under section 406(b) of the Federal Aviation Act should not be construed to deprive TWA of the benefits of a tax statute enacted for a similar purpose. This is especially significant since the Board encouraged and assisted TWA in securing a certificate of necessity under the tax statute. TWA should not be penalized for becoming independent of subsidy before the deferred taxes were actually paid, or for subsequently incurring operating losses and thereby becoming eligible for a loss carry-back refund under different provisions of the tax statute.

Holding that the reserve for "deferred taxes" under section 168 of the Internal Revenue Code of 1954 is a legitimate expense of the carrier recognizes the "need" of the carrier under section 406 of the Act since the reserve was earmarked for future payment and was in fact paid. The decision of the majority to the contrary completely disregards the tax statute and the intent of the Congress in enacting that statute in the interest of the national defense.

/s/ CHAN GURNEY

/s/ WHITNEY GILLILLAND

16743

GILLILLAND, MEMBER, FURTHER DISSENTING:

Contrary to the Board's finding, the entire cost of the 1953 navigators' strike was incurred under honest, efficient, and economical management, and should be allowed as an expense in computing TWA's breakeven need.

The Board concluded that two-thirds of the strike losses should be attributed to failures of honest, economical, and efficient management on the part of TWA because the carrier did not make "a special effort to soothe the feelings of its employees" by advising them of future management plans. In view of the circumstances of this case TWA's actions cannot be considered by any criteria, statutory or otherwise, as being unreasonable or constituting dishonest, uneconomical, or inefficient management.

As the record clearly shows, and the Board concedes, the strike was illegal, called in violation of the nonstrike pledge in the collective bargaining agreement between TWA and the navigators, not in response to any violation by TWA of the agreement, and not even in accordance with the union's own strike procedure. Furthermore, the record shows that, at all times prior to and during the strike, TWA acted strictly in accordance with its legal and contractual rights and obligations, whereas, the navigators did not.

The primary cause of the strike was the unreasonable demand by

16744

the navigators for job security, which they had already knowingly relinquished, and the unfounded assertion that *TWA was guilty of "provocative and unlawful evasion"* of the navigators' collective bargaining agreement. Under such circumstances TWA had no alternative but to refuse

to accede to the unreasonable demand of the union to reinstate the discharged navigators. This was a lawful and reasonable exercise of managerial judgment. The Board, on the other hand, now alleges if TWA had advised the navigators that it would not be necessary to furlough them until some future date, the strike in all probability would not have taken place, or been prolonged beyond July 13. This is pure speculation on the part of the Board and the statutory test of honest, economical, and efficient management is a factual one and not speculative.

TWA by maintaining its position and insisting upon the preservation of its contract rights until July 21 acted in a legal and reasonable manner, since it was then able to resolve prospective questions with respect to the elimination of navigators when ground radio facilities became available. Of utmost importance to TWA's position was the fact that the mediation agreement signed on July 21, 1963, contained an admission by the union that it was in violation of the Railway Labor Act, the collective bargaining agreement and, further, that the union fully recognized the inherent rights of the company to operate flights without navigators over any of

16745

After a prehearing conference the Board severed the portion of the proceeding dealing with AOA, and prior to the hearing Bureau Counsel, TWA and the Post Office Department stipulated that the sum of $218,591 would be fair and reasonable allowance to TWA for capitalization interest on equipment purchase funds in addition to the amount of such allowance included in prior findings of the Board.

Following the submission of exhibits and written testimony a public hearing was held and briefs were filed.

(16746)

16746

Order No. E-22022

UNITED STATES OF AMERICA

CIVIL AERONAUTICS BOARD

WASHINGTON, D. C.

Adopted by the Civil Aeronautics Board
at its office in Washington, D.C.,
on the 12th day of April, 1965

REOPENED TRANSATLANTIC FINAL MAIL RATE CASE (Trans World Airlines, Inc.)	Docket No. 1706, *et al.*

ORDER

A full public hearing having been held in the above-entitled proceeding, and the Board, upon consideration of the record, having issued its opinion containing its findings, conclusions, and decision, which is attached hereto and made a part hereof;

IT IS ORDERED:

1. That, subject to the provision stated in paragraph 3 hereof, the fair and reasonable rate of compensation to be paid under section 406 of the Act to Trans World Airlines, Inc., for the period February 5, 1946 through December 31, 1953, for the transportation of mail by aircraft, the facilities used and useful therefor, and the services connected therewith, between the points between which it was

then authorized to carry mail by its certificates of public convenience and necessity, other than certificates authorizing (1) interstate air transportation as defined in the Federal Aviation Act, and (2) air transportation between the United States and terminal points in Canada, is the sum of $48,633,000.

2. That the compensation provided by the rate fixed herein shall be in lieu of and not in addition to the mail compensation heretofore received by Trans World Airlines, Inc., for the services and period specified in the preceding paragraph.

3. That the rate of compensation fixed hereby shall be subject to further adjustment to reflect properly such actual tax credits as may ultimately accrue to the carrier as a result of the payback required hereby.

16747

4. That, except to the extent otherwise indicated, all applications, petitions, and motions involved in this proceeding are hereby denied; and

5. That this order shall be effective immediately.

By the Civil Aeronautics Board:

HAROLD R. SANDERSON
Secretary

(SEAL)

16748

Appendix A

Excerpts from the Initial Decision

of

James S. Keith

in the

Reopened Transatlantic Final Mail Rate Case

Docket 1706 *et al.*

• • • •

This initial decision is directed to a limited phase of the above-entitled proceeding which concerns the fixing of the final mail pay of Trans World Airlines, Inc. (TWA) for the period February 5, 1946, through December 31, 1953.

During the period in question, under temporary rate orders, TWA received mail pay in the amount of $51,095,000. In its so-called final decision on the last remaining phase of this proceeding the Board determined, among other things, that the fair and reasonable rate of compensation for TWA for the period in question, after offset of excess earnings from the carrier's domestic operations, was $42,942,000.[1]

Under this determination TWA would have been compelled to repay $8,153,000 to the Government from the amount of temporary compensation previously received. TWA sought a court review of the Board orders[2] fixing its mail rates, and, in *Trans World Airlines, Inc.* v. *Civil Aeronautics Board*, 254 F. 2d 90 (1958), the U. S. Court

---

1 *Transatlantic Final Mail Rate Case, Reopened*, 23 C.A.B. 307 (1956).

2 Orders E-10117, March 23, 1956, and E-10176, April 9, 1956, *Transatlantic Final Mail Rate Case, Reopened, supra*, and earlier orders reflected in such decision.

of Appeals for the District of Columbia Circuit, without passing on the merits of TWA's appeal, vacated the Board's orders and remanded the case for reconsideration because of the failure of the then Chairman of the Board to disqualify

16749

himself from consideration of the case in view of his prior participation as Solicitor of the Post Office Department. A companion case,[3] involving American Overseas Airlines, Inc. (AOA), arising out of an appeal of the same orders, was also remanded for reconsideration, this one because of insufficient findings with reference to disallowance of strike costs.

As a result of the Court's mandates in these cases the Board invited each party to the proceeding to file a statement of its views as to how best accomplish an expeditious compliance with the Court's decision. Following a response in the form of joint statements filed by AOA, TWA, the Postmaster General, and Bureau Counsel, the Board ordered[4] the proceeding reopened to consider the following issues:

1. To what extent, if any, should the mail rates of AOA and TWA include allowance for costs incurred in connection with TWA and AOA pilots' strikes of 1946 and 1947 and the TWA navigators' strike of 1953?
2. What, if any, allowance should be made for deferred taxes related to accelerated amortization taken by TWA for tax purposes under Section 124A of the Internal Revenue Code of 1950?
3. What is the proper amount to be allowed TWA for capitalized interest on equipment purchase funds?

---

3 *American Overseas Airlines* v. *Civil Aeronautics Board*, 254 F. 2d 744 (1958).

4 Order E-13220, 28 C.A.B. 959.

(16750, 16751)

16750

After a prehearing conference the Board severed the portion of the proceeding dealing with AOA,[4] and prior to the hearing Bureau Counsel, TWA and the Post Office Department stipulated that the sum of $218,591 would be fair and reasonable allowance to TWA for capitalization interest on equipment purchase funds, in addition to the amount of such allowance included in prior findings of the Board.

Following the submission of exhibits and written testimony a public hearing was held and briefs were filed.

16751

I. The Strike Issues

Scope of the Issues. During the mail pay period under review in this case TWA experienced two strikes, a pilot strike in 1946 and a navigator strike in 1953, with the result that it sustained substantial losses. These losses were handled as expense items by TWA in computing its subsidy entitlement but the Board disallowed them on the ground that "sound public policy requires that we refuse to underwrite losses attributable to a labor controversy without regard to responsibility therefor." The Board did not attempt to determine whether these strikes or the 1947 strike of the AOA pilots and the losses attendant thereto occurred or would have occurred notwithstanding honest, economical, and efficient management.

As noted above in the *AOA Case*,[5] the Board's refusal to recognize strike losses on policy grounds was reversed because of insufficient findings. The court noted that matters of general policy, apart from the terms of the statute, are not to be used as guides for decision, and that

5 See Footnote 3.

a policy as to labor disputes is not a factor to be considered in the determination of mail pay under the statute. In the order reopening this proceeding[6] the Board adverted to the court's mandate and outlined the matters which it believed were pertinent to consider:

> "In remanding the AOA case to the Board, the court made clear that we not only are required to pass upon the issue of managerial responsibility for the strikes, but that 'even if a finding be made that the strike occurred regardless of blameless
>
> 16752
>
> management, the problem still remains as to the amount of the need of the carrier for funds sufficient to enable it to maintain and to continue to develop, etc. This latter is a question of fact to be determined in each case.' Among the matters which the court believed were pertinent in this connection was whether the strike losses can and should be charged against the carrier's return and, if so, how much such return should be. We are also enjoined to consider the nature and extent to which maintenance and development of the particular company would contribute to the statutory purposes set forth in section 406 and the amounts needed to achieve these objectives. Accordingly, we will reopen the record for receipt of evidence on all phases of the issues of the strikes other than the issue of economy and efficiency with respect to the two pilots' strikes."

---

6 Order E-13220, *supra*.

Thus, at the prehearing conference and in the report thereof issued October 26, 1961,[7] it was determined that the strike issues to be decided herein are as follows:

1. Were the costs of the TWA pilot strike in 1946 and the navigator strike in 1953 incurred under honest, economical and efficient management?

2. Is a 7 percent rate of return provided by the Board for a past rate period a proper rate of return? Does it include an allowance for the risk or the possibility of strike or strikes during such period? If such rate does not provide a fair return what should the proper rate be?

16753

3. Does the 8 percent rate of return provided by the Board for future rate periods include an allowance for the risk or possibility that a strike or strikes will occur during such periods?

4. Was the compensation awarded TWA by previous Board orders in this case for the past mail-rate period in question sufficient together with all other revenues of the carrier to enable TWA to maintain and continue the development of air transportation to the extent and of the character and quality required for the commerce of the United States, the Postal Service, and the National Defense?

---

7 *See also*: Notice to All Parties dated December 20, 1961, for further amplification.

(16753, 16754)

The 1946 Pilot Strike. On Saturday morning October 19, 1946, David L. Behncke, President of the Air Line Pilots Association appeared in the office of TWA's President, Jack Frye, and handed the latter a memorandum demanding substantial wage increases for pilots flying Douglas Skymaster and Lockheed Constellation aircraft. Mr. Behncke stated that these demands must be met by TWA not later than Sunday evening October 20, 1946, just 30 hours away.

On Sunday morning Mr. Frye delivered a written reply to ALPA's demands, in which he stated, among other things:

> "I recognize that certain inequities exist, but it is also apparent that this is a matter of too great importance to the pilots and the Company to require us to reach a full settlement on all points within the time limit you imposed. I am, however, confident that if representatives of the pilots will now meet with representatives of the Company, beginning immediately, at any point you may suggest, it should be possible to solve the problems. I therefore urge you to set a time and place, satisfactory to you, at which such discussions can be inaugurated."

16754

ALPA did not reply to this communication and without notice the pilots stopped flying on October 21, 1946. They remained on strike until November 15, 1946.

During the 25-day strike period TWA's domestic and international services were at a standstill and the carrier

received no revenue whatsoever. To reduce its costs TWA furloughed, without pay, most of its employees. It retained only a skeleton force necessary to protect company property and to meet company commitments. Despite these efforts to economize, TWA sustained heavy operating losses. Its domestic division net losses, which amounted to nearly $11 million dollars in 1946, would have been reduced by $1,130,000 had the strike not occurred and the Atlantic division net loss for 1946 would have been cut by $582,000.[7a]

The chronology of events leading up to Mr. Behncke's demands of October 19 begin with the period immediately following V-J Day when it became apparent that four-engine aircraft of the Skymaster and Constellation type would be available for future commercial airline operations. The Federal government had advised the major airlines that these aircraft would be made available to them, and on this basis TWA began planning to inaugurate its newly authorized international service with such equipment.

At this time rates of pay for pilots and co-pilots operating four-engine aircraft had not been established and since it was evident that this would be a problem in the immediate future, TWA addressed a letter

16755

to ALPA inviting discussion on the subject as well as working conditions on TWA's international route. There-

---

7a These strike costs were computed by the Bureau and are not disputed by TWA.

after, by mutual consent TWA and ALPA began negotiations on rates of pay and working rules for the pilots and copilots of Skymaster and Constellation aircraft. Conferences were held intermittently between November 28 and December 12, 1945. On the latter date, when it appeared that no agreement would be reached, TWA invoked the services of the National Mediation Board. The case was docketed and a mediator was assigned to handle it. Within the week the mediator gave up hope of securing a settlement by agreement, and on December 19 a formal proffer of arbitration as required by the Railway Labor Act was submitted to the parties. The pilots accepted arbitration but TWA withdrew its application and the case was closed.

The pilots association immediately notified the Mediation Board that it was invoking the Board's services on the same issues and a formal application for mediation was filed with the Board on December 21. The case was docketed and assigned for mediation to Board Member Frank P. Douglass.

Meanwhile, on December 18, pursuant to the existing collective bargaining agreement TWA issued the usual type of bulletin requesting its pilots to bid for the openings on its new international routes. Although the offer was open until January 2, 1946, the pilots did not bid. Hence, on January 8, 1946, pursuant to the provisions of its collective bargaining agreement, TWA ordered its most junior qualified pilots to report for duty. On February 5, 1946, after these pilots were checked-out in accordance with CAA requirements, TWA inaugurated service over its international routes.

16756

The mediation conference assigned to Member Douglass

began in Chicago on January 11, 1946, with all three members of the Mediation Board present. These meetings were continued through January 14 but they ended in disagreement on the latter date because of a controversy over the right of the Airline Negotiating Committee (ANC) to represent the airline carriers. This committee was formed in the latter part of 1945 by the 13 major airlines to act as their collective bargaining representative in negotiating agreements of rates of pay and rules for flying the new four-engine equipment both in domestic and international service. Each airline had executed a power of attorney to this committee to act as its collective bargaining representative.

On December 28 the chairman of the ANC notified ALPA's president of the ANC's existence and requested his cooperation in handling, on an industry-wide basis, the problems raised by the new equipment. On January 10, 1946, the president of ALPA replied that the union "stands ready to deal singly with the duly authorized representatives on behalf of a company • • • in the same manner that each of the existing pilots' employment agreements were negotiated." This message was supplemented by another one on January 22 stating that counsel for the pilots association had advised that the ANC "is in violation of law."

When the ANC appeared at the mediation conferences in Chicago to represent TWA this controversy became the major issue. An agreement on the pay and rules issues became impossible.

On January 24 the mediation proceedings were resumed

in Washington under Board Member Douglass and the meetings continued through January 27 when they were recessed until February 4. This time discussions were

16757

confined to the pay and rules questions of TWA's case. The pilots association apparently had no objection to dealing with the ANC as the representative of TWA.

However, before these proceedings were recessed the Mediation Board accepted an application from ALPA for mediation of disputes involving the same issues on rates of pay and rules of the American Airlines, and it docketed this case; and also, just after the recess, on January 29, ANC by telegram applied for mediation on behalf of each of the other 11 airline companies represented by ANC. These cases were assigned to Mediator Ross Foran who was also assigned to take over the recessed proceedings involving TWA. On February 1 the Mediation Board advised ANC and ALPA that all of these disputes would be heard concurrently in New York before Mediator Foran beginning February 4.

ALPA vigorously protested the transfer of mediation proceedings from Washington to New York as well as to the concurrent handling of the cases. It also complained of changing mediators and insisted that the mediation proceedings involving only TWA be resumed in Washington as had been the understanding at the time of the recess on January 29.

At the direction of the Mediation Board, Foran resumed meetings in Washington February 6-12. The pilots' representatives understood that only the TWA case was being

mediated and considerable progress was made at these meetings toward agreeing on an arbitration submission. But no agreement was reached because the carriers wanted any arbitration award to be applicable to all the airlines, whereas the pilots insisted that it must be limited to TWA.

16758

On February 12, at the request of ANC, the Mediation Board transferred the conference to New York and by telegram notified the pilots that the mediator would continue mediation there on February 13, not only of the TWA case, but the other cases as well. At first the pilots' representatives refused to appear in New York, but on February 14 they did appear and insisted that they were not authorized to deal with any case other than that involving TWA. They objected further that the other cases were not properly before the Mediation Board because necessary notices had not been given by the airlines requesting changes in existing contracts which did not expire for some time.

On February 15, although much of the Chicago and Washington conferences had been concerned wtih the wording of the agreement to arbitrate, a formal proffer of arbitration was again presented to the parties as had been done December 19 but which was not accepted by TWA.

This time both ANC and ALPA accepted, the former on February 18 and the latter on February 21. From

February 27 to March 8 additional meetings were held in New York in further attempts to agree on the wording of the questions to be arbitrated.

While these efforts were being made a misunderstanding developed between ANC and the Secretary of the Mediation Board which prompted the former temporarily to withdraw its acceptance of arbitration. When the mediator advised ALPA of these developments, the latter replied in a wire (March 11) as follows:

> "There is nothing further that the association can do except take the strike vote which is now in progress covering pilots and copilots in domestic and international operations of TWA."

16759

Meanwhile as a result of a communication between the Secretary of the Mediation Board and ANC on March 7, the latter reinstituted ANC's acceptance of arbitration on March 12. The same date the Mediation Board wired both parties as follows:

> "In view of the likelihood that the mediator will now be able to secure an arbitration agreement in this dispute we urge that the strike vote be abandoned and both parties cooperate with the mediator in working out the details of the question to be arbitrated."

When arrangements were being made for resuming meetings in New York to work out the arbitration questions further misunderstandings developed out of the attempt to mediate the 13 airline disputes concurrently. A joint meeting for the purpose of wording the TWA arbitration question could not be arranged until March 26 although the representatives of ALPA arrived in New York on the

20th prepared to do so. They insisted, however, that they were not authorized to deal with the other 12 cases. The Mediation Board and ANC wanted all of the cases disposed of and there was maneuvering to get the arbitration to cover them all.

In the interim while the acceptance of TWA's arbitration had been withdrawn, mediation of American Airlines' case had begun. However, a conference lasting from February 27 to March 8 ended in a failure because the issues were the same in the TWA case. Between March 12 and 16, because the mediator felt that it would be helpful in resolving the TWA dispute, he settled a case involving American Overseas Airlines which was not included in the 13 other airline cases. However, he was unable to arrange a meeting of the parties for disposing of the TWA case because

16760

ANC still wanted to handle all of the cases together and ALPA refused to deal with ANC on this basis.

Thus, on March 26 when the meeting was finally held to discuss the wording of the arbitration question it ended in a deadlock. The ANC insisted that arbitration awarded must be applied to all of the cases while ALPA took the position that it must be applicable to TWA only. The pilots' representatives immediately left New York and the next day notified the Mediation Board that the strike vote of all the TWA pilots had been completed and that they had voted overwhelmingly for a strike.

On the same day, March 27, the Mediation Board wired ALPA that further mediation by the mediator was suspended and that the Board Members themselves would begin mediation in New York on April 1. On the appointed day ALPA appeared by its attorney and another representative but they would not discuss any issue other

than that involving TWA. The Board attempted for three days to mediate all of the airline cases concurrently and on April 3 made a formal proffer of arbitration to both ANC and ALPA parties, including all of the airline cases. ANC accepted but the pilots gave no answer. ALPA notified the Board that it was proceeding with the strike on TWA, beginning sometime in the week of April 21.

Shortly thereafter, the National Mediation Board found that "these disputes * * * threaten substantially to interrupt interstate commerce;" and on May 7 the President of the United States created a three-man Emergency Board to investigate the TWA dispute and those involving other airlines.

16761

After hearings, the Emergency Board, on July 8, 1946, rendered its report to the President unanimously recommending a new pay scale for TWA's international operations and that the disputes involving the other carriers be referred back to the parties for further action. On August 8, 1946, upon the expiration of the 30-day waiting period prescribed by the Railway Labor Act, TWA put into effect the wage-scale recommended by the Emergency Board. The union announced later to the press that it would not accept the recommendations of the Emergency Board.

It was thereafter, on Saturday morning, October 19, 1946, that the president of ALPA made the written demands on TWA that resulted in the strike from October 21 to November 15, 1946. The demands involved wage increases amounting to approximately $3,000 a year per pilot more than the Emergency Board recommendations.

On the date the strike began TWA communicated with the Chairman of the Civil Aeronautics Board and other Government agencies suggesting that the Government take

over control of the airline.[8] It appears that several departments favored TWA's request, but when the Chairman of the Civil Aeronautics Board would not join with the others it was evident that this course of action would yield nothing.

16762

On October 24, 1946, TWA resumed negotiations with the union and these negotiations continued until October 30 without any settlement being reached. At this point the Chairman of the National Mediation Board recommended that the pilots return to work, negotiate their differences with the carrier for one week, and that any remaining disagreements be submitted to arbitration. TWA immediately accepted this recommendation but ALPA refused. The following day, the Chairman of the National Mediation Board proposed that the parties submit all points in dispute to formal arbitration agreement. A draft of such agreement was prepared by the Chairman, signed by TWA and deposited with the National Mediation Board on November 5, 1946. This also was not acceptable to the union, but after 10 days of further negotiations another agreement was signed by both parties and the pilots terminated their strike.

The arbitration award covering 1946-47 pilot pay granted DC-4 pilots an annual salary of $11,232 or $1,653 less per year than that demanded by the union on October 19, 1946, and Constellation pilots $12,048 per annum or $2,674 per year less than the union demanded. Subsequent collective bargaining agreements covering the 1948-51 period fixed pilot salaries at higher levels but still significantly less than the demands of the union.

---

8 Since the wartime emergency had not been terminated at the time the strike occurred, the President had the power to take possession and assume control of TWA's system in accordance with Section 1361, Title 10 U.S. Code. The President used this power in the case of the railroads and it was exercised again in 1948 when the railroads accepted an Emergency Board recommendation which the railroad unions rejected.

The 1953 Navigator Strike. With the outbreak of World War II, TWA hired navigators for its overseas military operations with the Air Transport Command. They were used in areas or on routes lacking ground navigation facilities and which required celestial navigation. Their

16763

future depended on the continued absence of ground-based radio communication facilities.

By 1948 ground stations had been established on a number of international routes including those extending from Shannon over the continent of Europe, and celestial navigation was no longer necessary over these routes. In that year TWA filed an application with the Civil Aeronautics Administration requesting approval of its plans to discontinue navigators on certain European routes. However, the proposal was dropped because of the questionable availabilty of ground navigational aids.

In 1949 during the negotiations on the collective bargaining agreement between TWA and the union, there were discussions with reference to the elimination of navigators on certain European segments. These discussions resulted in an agreement providing under section 17(m), for severance pay where navigators might be "hereinafter furloughed as a direct result of the discontinuance of the use of navigators over all or any of the company's routes or segments thereof."

The possible elimination of navigators on certain routes again arose during the negotiations on the 1952-1953 collective bargaining agreement which was docketed by the National Mediation Board.[8a] This was evidenced by TWA's application with the CAA requesting approval of their plans to eliminate navigators on certain of TWA's European route segments, including those involving Paris-

---

8a After the negotiations reached an impasse and on a strike vote of the union, TWA had petitioned for mediation.

Rome. The Civil Aeronautics Administration notified the navigators of TWA's proposal and requested their

comments. The reaction of the navigators is reflected in a telegram to the National Mediation Board and TWA on July 21, 1952, which states, in part:

> "This wire is to notify you that the union will not tolerate this flagrant disregard of the agreement and action of bad faith and intimidation on the part of the management and unless the Board invokes immediately the status quo and the company withdraws its application and immediately ceases to interfere with the navigators performing their duties while there is a contract dispute between the parties, the union will revert to its original position prior to the carrier requesting the services of the National Mediation Board."

Despite the union's strike threat, negotiations continued under the auspices of the Mediation Board, and on November 7 and 8, 1952, agreements were reached, one for the 1952-53 period and the other for July 1, 1953-June 30, 1954. Each of these agreements contained a Section 17(m) similar to Section 17(m) of the 1949 agreement which provided that a navigator furloughed as a direct result of the discontinuance of the use of navigators over any of the company's routes who has not been recalled to duty within one year from the date of furlough must notify the company of his election to accept one of the following alternatives: (a) severance pay; (b) other employment with TWA; or (c) remain on furlough.

On November 8, 1952, TWA by letter to the president of the navigators' union, agreed to waive the one-year waiting period for election for the reason that:

"Because of the particular circumstances existing with regard to the present and future utilization of navigators and because it is recognized by the company that any future furlough of navigators will probably be because of the discontinuance of navigators over certain of the company's routes or segments thereof."

16765

The letter in question became part of Section 17(m) in each agreement on December 24, 1952.

In April 1953 TWA's application to discontinue navigators on the Paris-Rome segments was tentatively approved by the Civil Aeronautics Administration, and on June 5, 1953, it was officially approved by that agency to be effective June 8, 1953.

On June 9, 1953, TWA's general operations manager issued staff instructions to implement the program, effective July 1, 1953. Among other things, his instructions directed that the navigators union be advised of the program by June 9. Pursuant to these instructions "the proper union heads were notified as to the date of implementation."

There is no evidence of any reaction by the navigators until June 25, 1953, when the vice-president of the navigators' union personally delivered to TWA's president a letter in which the union stressed advantages of retaining navigators on the Paris-Rome segments of TWA's routes and contended that TWA might be making a mistake in discontinuing their use. The letter concludes with the following paragraph:

"In summarizing, we have shown by our figures, after writing off navigational costs, the company will realize a saving of over $6,000.00 per week on this 600 mile Paris-Rome segment alone. This is

progress which directly reflects savings to the company. We hope we will be able to meet with you at your earliest convenience to discuss this matter further."

The letter was referred to TWA's Kansas City office on June 29, 1953, for reply through regular channels.

16766

On July 1, 1953, TWA discontinued using navigators on its Paris-Rome flights. However, since TWA had increased operations over other segments requiring celestial navigation, it did not anticipate any immediate furloughs. Hence, no furlough notices were issued as required by the collective bargaining agreement. In fact no navigators were furloughed until 1958, five years after the strike.

Despite the fact that immediate furloughs were not involved, on July 7, 1953, the president of the navigators' union wired TWA's vice-president of Industrial Relations, characterizing the carrier's action as "provocative and unlawful evasion of navigators collective bargaining agreement," and demanding an immediate hearing in New York City between management and union representatives. The telegram also advised TWA that the National Mediation Board was being notified that the company's action "so undermines the basis upon which increment agreement was predicated that it has reopened the agreement and requires renegotiation at once and restoration to status quo until question is resolved." TWA immediately responded denying the charges of the union, and advising the union that it would be available for discussions in Kansas City at any time on or after July 10, 1953.

A meeting of the union's executive committee was called on the evening of July 9, 1953. Among those present was the union's attorney, one of the principal witnesses in this case. He testified that the committee was "highly incensed

and confused by TWA's actions" and that it took the view that a proposed survey flight by TWA from the United States to Europe via Greenland without a navigator aboard, was intended

16767

to provide a means of crossing the Atlantic without navigators, and that the discontinuance of use of navigators over the Rome to Paris segment was an initial step in a plan to discontinue use of all navigators on TWA's European routes. According to the witness, the committee persisted in the position taken by the president of the union in its telegram of July 7 that the increment agreement contained in the collective bargaining agreement with TWA assumed that there would be no discontinuance of the use of navigators on any portion of TWA's routes during the term of the agreement, and that the company action constituted not only a threat to job security but also a threat of reduction in pay, in violation of the intent of the agreement. The committee took the position that the Adjustment Board method of settling disputes would not be adequate under these circumstances and that a strike would be the only way to get the company to discuss the problem with the union. The witness testified that he informed the committee that the International Union would not approve or authorize a strike.

Notwithstanding the advice of its legal counsel at the meeting and a subsequent promise by the International Union that it would seek to win redress against TWA for any violation of the labor contract, the navigators called a strike beginning at noon on July 10, 1953. The strike was not authorized by any strike vote of the membership and was called without the approval of the president of the Transport Workers Union of America, C.I.O., as required by the union's constitution.

During the afternoon of July 10 the union's attorney re-

ceived a call from an employee of the National Mediation Board advising him that TWA's vice-president of industrial relations was coming to New York City

16768

that day, and suggested that the union's attorney get in touch with that official to arrange a meeting. Attempts by the union's counsel to reach TWA's vice-president failed, and although a message was left for TWA's vice-president to contact the union's representative, there was no answer to this message.

Meanwhile, TWA discharged each navigator that refused his flight. On July 11 a member of the National Mediation Board came to New York for the purpose of mediating the dispute. As was the apparent practice at that time the mediator met separately with each of the disputants, first talking to TWA and then to representatives of the navigators, including the union's attorney and an official of the International Union. TWA would not discuss the strike situation directly with union officials until the navigators agreed to return to their jobs, and the navigators would not agree to return to work until TWA would agree to reinstate the discharged navigators.

On July 12 TWA's vice-president met with representatives of the union's interest (as distinguished from union officials) but they could not reach an agreement. The union's counsel advised TWA that "the temperament of the navigators was such at that point that any suggestion of settlement without reinstatement of the discharged employees would be unacceptable to them." TWA, however, refused to reinstate the discharged navigators.

Thereafter, the mediator suggested a mediation agreement under which the strike action would be annulled, the navigators would return to duty and there would be an immediate conference on the status of

16769

the dismissed strikers. This proposal, however, was rejected by the union and other proposed mediation agreements were unacceptable to the parties. The discussions ended on July 13 without any progress and the mediator returned to Washington.

Finally, on July 20, TWA and union representatives agreed to discuss the matter further and on July 21 a mediation agreement was signed which provided for reinstatement of all navigators. The agreement contained an admission by the union that it was in violation of the Railway Labor Act and the collective bargaining agreement, and that the union recognized the inherent right of the company to operate flights without navigators over its routes or segments.

TWA's losses as a result of this strike which affected only its International Division were $1,033,000.

Were the Strike Costs incurred under Honest, Economic and Efficient Management? The Bureau claims that TWA's designation and use of the ANC as its authorized bargaining representative over the objection of the union was the basic cause of the 1946 strike, and that TWA's failure to discuss the impact of eliminating navigators on the Paris-Rome segments on future job security of the class of employees prior to the strike was the principal reason for the 1953 strike. On this reasoning, the Bureau concludes that TWA's management was not honest, economical and efficient in handling the strikes and that therefore the cost of the strikes should not be recognized as an expense in fixing TWA's final mail rate.

16770

A more prudent and reasonable approach to handling the inflammatory pilot situation, according to the Bureau,

would have been by a continuation of TWA's individual carrier discussions with the union rather than on an industry-wide basis. As to the navigators the Bureau concedes that some blame for the 1953 strike must fall on the union. However, the Bureau charges that TWA was imprudent in handling its labor relations with this group of employees, particularly after the strike was called. The Bureau theorizes that the strike would not have occurred had TWA communicated with the navigators and explained its proposal prior to taking its action, effective July 1, and further speculates that once the strike occurred, the costs connected therewith could have been minimized by prompt discussions with union representatives.

TWA could not disagree more strongly. It argues that so far as the pilot strike is concerned the only way that this strike could have been avoided would have been by complete surrender to the union demands. Had it done so the additional pilots' salaries that TWA and other airlines would have had to pay would have been substantial not only for 1946 but for subsequent years as well. TWA claims that it attempted not only to terminate the strike at the earliest possible date but that it also exerted every effort during the strike to reduce costs by furloughing all employees except for a skeleton force. In these circumstances TWA insists that its management was honest, economical and efficient in handling the pilot strike.

16771

As to the navigator strike, TWA contends that by standing on its contract rights and invoking the services of the National Mediation Board to end the unlawful walkout its action was reasonable, efficient and economical. To the extent the strike was prolonged, TWA contends that it was prolonged by the union's refusal to adopt the mediator's proposal that there be an immediate return to work ac-

companied by a conference on the status of the strikers and further by the union's insistence that talks be on the union's own terms.

With the advantage of hindsight it would appear that TWA's management, in handling the 1946 pilot wage and rules dispute, would have been better off had it continued individual negotiations with ALPA rather than delegating its collective bargaining functions to ANC. Certainly, as the events leading up to the strike show the industry-wide bargaining approach insisted upon by ANC and the concurrent handling of each air carrier case by the Mediation Board did not facilitate a settlement of the controversy. But this does not establish that TWA's managament was uneconomic and inefficient.

Assessing the situation in the light of the times, it would seem eminently unfair to hold that TWA's management acted imprudently in dealing with its pilot strike. At the time ANC was organized it was customary for most labor organizations to want industry-wide bargaining. Hence, it was not unreasonable for TWA and the other air carriers to create a committee which would facilitate this method of bargaining.

Legally, there could be no question as to each carrier's right to designate ANC as its authorized bargaining representative. The only

16772

problem was whether each carrier's case could be disposed of on a consolidated basis, and the Mediation Board resolved this by holding that the Railway Labor Act contemplated separate bargaining with each carrier. However, the Mediation Board favored concurrent mediation and a single arbitration agreement, and its position in this matter was not conducive to settling the TWA dispute.

While TWA's management selected ANC as the carrier's

bargaining representative and ANC insisted on an industry-wide settlement, the Mediation Board was not compelled to handle the various cases on a concurrent basis. If it had mediated each case separately and independently of the other ALPA may not have been irritated to the point of issuing the notice of strike for the week of April 21. Perhaps the TWA case could have been settled before reaching the Emergency Board stage. But having reached that stage, the strike could still have been averted had the union accepted the Emergency Board recommendations which were satisfactory to TWA.

No longer was a settlement of the TWA dispute geared to an industry-wide settlement which had been ALPA's principal objections to the earlier negotiations. The Emergency Board had separated the TWA case and issued wage and rules recommendations respecting that carrier alone. The other air carrier cases, according to the Emergency Board, should be referred back to the parties for negotiation or settlement on the basis of the TWA recommendations.

Thus, after the Emergency Board Report of July 8, 1946, it is difficult to assign ALPA's displeasure with the Emergency Board recommendations to any of the activities of ANC. Its dissatisfaction apparently was related to the Board's wage-scale recommendations and this obviously led

ALPA to its sudden demands of October 19 and the strike that began on October 21, 1946.

When it presented its wage demands to TWA's president on the morning of October 19 it allowed practically no time for discussion. TWA's response was conciliatory and under these conditions, it could not be considered as provocative or imprudent. For the carrier to have sub-

mitted to the demands without further negotiation would have been uneconomic and inefficient.

• • • •

• • • It is further found that after the strike began TWA followed every reasonable means to terminate the strike at the earliest date and it made every reasonable effort to reduce the cost of the strike.

Turning now to the navigator strike, the facts do not warrant the conclusion that TWA's management was responsible for this strike. The 1949 collective bargaining agreement between TWA and the navigators and those subsequent thereto afford documentary proof of the carrier's intention to eliminate navigators on any of TWA's routes not requiring celestial navigation; and the company's application in the summer of 1952 to the Civil Aeronautics Administration requesting approval of its plan to eliminate navigators on certain European route segments, including those involving Paris-Rome, apprised the union of the imminence of this plan. Further indication of the seriousness of this plan must have been evident to the navigators when, in November 1952, TWA agreed to waive the one-year waiting period for furloughed navigators, and when several months later, in April 1953, the CAA tentatively approved TWA's application to eliminate navigators on the Paris-Rome segments.

16774

Thus, when the plan was officially approved by the CAA on June 5, 1953, and the navigators were notified on June 9 that TWA would implement the program, effective July 1, the union should not have been taken by surprise. In these circumstances, it is difficult to see how the Bureau attributes the strike to TWA's failure to discuss the impact of its program on the future job security of navigators. The successive collective bargaining agreements from 1949

through 1953 incorporated provisions for softening the impact of such a program. What then could be accomplished by discussions with the union that were not provided for by the current collective bargaining agreement? Perhaps TWA could have been more explicit to the navigators that no immediate furloughs were contemplated; but not having received furlough notices in accordance with the collective bargaining agreement, the navigators must have been aware that no immediate layoffs were planned.

Hence, there was no plausible basis for the union's action in calling the strike. Its explanation that TWA's plan violated the increment agreement was a feeble attempt to justify its action that failed to impress its own counsel or the National Union. In fact, as late as June 25 it had not made such a claim. Thus, up until the strike occurred there can be no question concerning the efficiency and economy of TWA's management. It was pursuing an economical and efficient objective in eliminating unnecessary costs and in pursuing this objective it did not act unreasonably or imprudently in dealing with its navigators.

After the strike occurred TWA refused to deal directly with union officials until the navigators returned to work. The navigators would

not return to work until TWA would agree to reinstate the discharged navigators. TWA did meet indirectly with the union on July 11 through a mediator and had direct discussions with the union's counsel (not an official of the union) on July 12 and 13. However, since it was adamant in its refusal to reinstate the discharged navigators and the union was equally adamant about returning to work without a reinstatement of the discharged navigators, the discussions broke off. The Bureau blames the impasse on TWA's management.

It is probably true that the strike would have been settled almost immediately if TWA's management had been more conciliatory. The same can be said if the union's position had been more flexible. The problem, however, is whether in spite of the union's position TWA's insistence on standing on its contract rights and refusing to yield except on its own terms was consistent with efficient and economical management in bringing the strike to a close.

While TWA's position had strong moral and legal justification, from a practical standpoint it is difficult to see what management hoped to accomplish by maintaining such position beyond the very early negotiations which took place on July 11, 12 and 13. There was no bargaining for wages or rules of employment involved. Apparently the main objective of management was to demonstrate its legal right under the collective bargaining agreement to discipline the recalcitrant navigators. If it had any idea of enforcing its contract rights by a suit in damages for breach of contract it dropped the idea by July 21 since the mediation agreement which it signed waived TWA's legal rights.

16776

Under the mediation agreement all of the discharged navigators were reinstated in exchange for certain disciplinary action against the navigators, including the loss of pay. According to the testimony of the union's counsel this is essentially what the union had been willing to settle for during the discussions on July 11, 12 and 13. Why then was it necessary for TWA's management to insist on all navigators returning to work before discussing discipline? As it turned out nothing of material importance was accomplished or could have been accomplished in relation to the cost involved.

As related earlier the strike which extended from July

10 to July 21 cost TWA $1,033,000. Most of this expense was incurred after July 13 and was unnecessary. It should have been evident to TWA's management by July 13 that a settlement of this strike could not be procured on the basis of its terms. Therefore, after this date the cost of the strike was not incurred under efficient and economical management, and it is so found.

Should TWA's Mail Rate include an Allowance for the Cost of the Strikes? In the previous decision in this case[10] which, as mentioned earlier, was reversed and remanded by the court for lack of sufficient findings, the Board refused to recognize strike losses for policy reasons,

16777

disagreeing with the Examiner who had concluded that the strike losses should be recognized as a proper business expense. In noting its disagreement the Board observed that the Examiner erred in relying on the premise that the Board, in *American Airlines, Inc. et al., Mail Rates,*[11] had reversed the general policy established in *Braniff Airways, Inc., Mail Rates,*[12] with respect to requiring abnormal risks which are neither predictable nor measurable to be met out of return on investment. In the *Braniff* case the Board held that losses attributable to the grounding of aircraft were properly chargeable to the rate of return. In the *American* case the costs were recognized and permitted to be capitalized. In the instant case the Board held that the *American* case was an exception to the general policy announced in the *Braniff* case, and in so holding it determined that the risk of strike losses must be met out of the return on investment.

---

10 Order E-8833, 19 C.A.B. 464, 466 (1954); and Supplemental Opinion on Reconsideration, Order E-9530, 21 C.A.B. 484, 485 (1955).

11 10 C.A.B. 341 (1949).

12 9 C.A.B. 607 (1948).

Referring further to the previous decision in this case, the Board agreed with a 7-percent rate of return recommended by the Examiner for the past period, but disagreed that such rate of return would not cover the strike losses. The Board pointed out that there was a great difference between a risk of strike and the loss occasioned thereby and it concluded that, viewed on an industry-wide basis, the strike risk was

16778

anything but a relatively small one. It found that there had been no showing that the strike risk represented more than a negligible part of the 7-percent rate of return on investment or that the 7-percent rate was inadequate to cover the risk.

The conclusions in the earlier decision are now open to change as a result of the court's decision and the Board's order reopening the proceeding. In view of the Board's language, as noted in its order, that——

> "Among the matters which the court believed were pertinent in this connection was *whether the strike losses can and should be charged against the carriers return, and if so, how much the return should be.*" (Emphasis added.)

the question is raised as to whether the Board's general policy established in the *Braniff* case and modified in the *American* case should be further altered by recognizing strike losses incurred under honest, efficient and economical management as a proper business expense or whether such losses can and should be charged to the carrier's rate of return, and if so, how much that return should be.

The Bureau would have the Board reaffirm its previous statement in this case to the effect that strike losses constitute abnormal, nonrecurring costs which are risks of

doing business and which must be borne by the shareholders out of the return on investment. The Bureau would also have the Board reaffirm its earlier conclusions that the 7-percent rate of return for the past period and 8-percent rate for the offset phase adequately cover the risk of strike losses. Aside from the return issue the Bureau argues that the strike costs should be disallowed because they did not contribute to the developmental purpose of the Act under Section 406(b).

16779

TWA adheres to its original position in this case that its mail pay should include full allowance for the 1946 and 1953 strike losses. It does not say how this allowance should be made. It does insist, however, that the 7-percent rate of return does not cover strikes, and in this respect it argues that the Board's previous decision, in adopting portions of the Examiner's report, clearly support this position.

Before turning to the problem of whether TWA's strike losses can and should be charged to the carrier's rate of return or whether such losses should be handled as an expense item, it is expedient to first consider the Bureau's contention that the strike costs should be disallowed because they did not contribute to the developmental purposes of the Act. If this is a valid argument then no useful purpose will be served in considering the rate of return versus expense item issue.

In advancing this argument, the Bureau points out that, in fixing mail rates the Board disallows many expenses, even where no managerial efficiency is involved, on the grounds that they do not contribute to service or serve one or more of the developmental purposes of the Act. Such expenses, it is pointed out, include charitable contributions and entertainment expenses, expense disallow-

ances and losses under military contracts, and expenses of prosecuting unsuccessful route applications. The Bureau insists that the strike losses fall within this category of expenses.

16780

To accept the validity of the Bureau's comparison is, of course, to agree with its contention that the strike losses should be disallowed. But the comparison is unacceptable. The expense items referred to have no bearing whatsoever on the certificated obligations of air carriers and are irrelevant to the maintenance or development of air transportation. On the other hand, the services of pilots and, in some cases, specialized navigators are indispensable to the maintenance of air transportation services. Strikes, therefore, by these employees have an intimate relation to the statutory purposes of Section 406(b). Admittedly, such strikes would not appear to make a contribution to the maintenance and development of air transportation, but by the same token it is difficult to see how floods, aircraft crashes, fires, abnormal weather conditions or the grounding of aircraft develop air transportation. The Board has recognized losses occasioned by the latter and in 1958 it even granted temporary subsidy to three airlines when their business was adversely affected by the Hawaiian sugar strike.[13] Strikes among airline employees are far more closely related to this group of operating expenses than to the category in which the Bureau would place them. Thus, if the former can be recognized for rate-making purposes, strikes which are similar and should also be allowed where management is not at fault.

---

13 Orders E-14106, June 25, 1959, and E-12371, April 16, 1958.

(16781, 16782)

• • • •

16781

In fixing the mail pay for TWA and Pan American in this proceeding it was necessary for the Board to consider their subsidy requirements in the light of excess earnings of their other divisions. *Delta Air Lines, Inc.* v. *Summerfield,* 347 U.S. 74 (1954). The Board therefore instituted the so-called offset phase for the purpose of considering whether the operating divisions of TWA and Pan American, other than their transatlantic divisions, had any earnings available to reduce the subsidy requirements of their transatlantic services.

With reference to TWA, the offset phase covered that carrier's domestic operations for the period from February 5, 1946, through March 1947, and from January 19, 1951, through December 1953. The intervening period extending from March 14, 1947, through December 31, 1950, was excluded from consideration since the Board had already fixed a past period rate for that period. Thus, the offset proceeding involved a determination of that carrier's excess earnings for its domestic operations for approximately one year between 1946-47 and three years 1951-53.

In determining the carrier's excess earnings the Board adopted the Bureau's computations which were based upon the carrier's net income, before taxes, as reported (Form 41 reports) for 1946, the first quarter of 1947, and the three-year period 1951-53. To these reported earnings certain accounting adjustments were made, plus a number of additional adjustments for rate-making purposes. The latter category included the usual rate-making disallowances, *viz.*, executive aircraft expenses, contributions, entertainment expenses and gifts, etc. In

16782

addition, it included the theoretical cost of TWA's 1946 pilot strike in the amount of $1,130,000. This amount was

calculated by assuming what TWA's earnings would have been had the 1946 strike not occurred.

The Board disallowed the computed strike loss as an improper expense item, not for the reason that the other disallowances were made, but because of the Board's earlier holding in this proceeding that strike losses constitute a risk of doing business which is reflected as a normal cost of capital rather than as an operating expense and, therefore, chargeable to return on investment.

As a result of this disallowance which has the same effect of any other disallowance for rate-making purposes TWA's net earnings for the year 1946, as reported, were increased by $1,130,000. In turn, the carrier's total earnings for the entire period under review increased by a like amount, and its excess earnings available for offset against its Atlantic division amounted to $1,130,000 more than they would have been had the disallowance not been made.

The Board's earlier decision in this case indicates that the ratemaking adjustments to the Form 41 reported earnings were the result of the Board's determination that "we should review the operations on our customary basis in order to determine the amount of earnings or deficiency which would have occurred under honest, economical and efficient management."[16] The Board concluded that it could not assay the honesty, economy and efficiency of a carrier's operations merely by scrutiny of results as reported by the carrier in its Form 41 reports.

16783

The necessity to cost TWA's strike losses in the offset period was thus occasioned by the Board's determination to review the carrier's operations on the customary basis so as to fix the amount of excess earnings, or deficiency that would have occurred under honest and efficient man-

16 *Transatlantic Final Mail Rate Case*, 19 C.A.B. 464, 634 (1954), Order E-8672.

agement. However, the Board did not elect to review the theoretical strike costs in the light of the honesty and efficiency of management. Rather, it decided that such costs were an improper operating expense and should be disallowed on this theory.

As previously determined herein, in fixing a past mail rate period, strike losses incurred under honest, efficient and economical management should be recognized as a normal expense of operation. Hence, if the offset phase is to be examined in the same perspective, then it would follow that the 1946 pilot strike loss must be recognized as a valid business expense since, as previously concluded, it was incurred under honest, efficient and economical management. In this situation, there would be no basis for a strike adjustment to TWA's 1946 net earnings as reported. The carrier's excess earnings for the offset period would be $1,130,000 less than the Board found.

On the other hand, recognizing that the 8-percent return fixed by the Board for the purpose of determining excess earnings is the normal future period rate of return for domestic operations, and that TWA was on a closed or future rate during the offset period, there is a substantial

16784

basis for holding that the 1946 strike losses are a risk of doing business chargeable to the carrier's return on investment. The Board's earlier opinion in this case so holds. * * *

* * * *

In summary, it is found that the mail rate of TWA for its transatlantic division during the period under review should make allowance for the strike losses of TWA incurred under honest, efficient and economical management. The allowance should include $582,000 for the cost of the 1946 pilot strike and $344,300 for the portion of the cost of the 1953 navigator strike which occurred under honest,

efficient and economical management.[18] It is further found that the amount previously determined by the Board as excess earnings from TWA's domestic operations available to reduce TWA's international need should be reduced by $1,130,000.

16785

ACCELERATED AMORTIZATION ISSUE

Background of the Dispute. In 1950, after the outbreak of the Korean hostilities, Congress enacted Section 124A of the Internal Revenue Code of 1939 (now Section 168 of the Internal Revenue Code of 1954) for the purpose of encouraging industries to acquire facilities "certified as necessary to the interest of the national defense during the emergency period." Under this legislation, any taxpayer who had received a certificate of necessity issued by the proper defense agency could elect to take depreciation on the facility or portion thereof covered by such certificate over a period of sixty months rather than over the normal life of such facility.

A taxpayer eligible to take advantage of this program obtained a substantial deduction against net income for income tax purposes during each of the first five years, and much smaller deductions therefrom during the remainder of the normal amortization period. If the income tax rates remained the same during the entire life of the facility, the same amount of taxes ultimately would be paid under either accelerated or normal amortization.

The air transport industry was eligible and did participate in this tax program with the encouragement of both the Civil Aeronautics Board and the Air Coordinating

---

18 The navigator strike extended over a period of 12 days, four of which were under honest and efficient management. Thus, one-third of the losses of $1,033,000 should be allowed.

Committee. A principal reason given by the latter for its endorsement of the program was that "a program for accelerated amortization will contribute toward easing the current financing problem of the airlines by increasing the liquid funds at their disposal."

16786

During the years 1950-1953 TWA purchased aircraft and other equipment for use on its domestic division, and it obtained the necessary certificates from the proper defense agency to cover a portion of such facilities under the tax benefits of section 124A. Specifically, certificates were issued during 1951, 1952 and 1953, certifying as being attributable to defense purposes, 80 percent of certain aircraft, engines and equipment and 60 percent of TWA's hangar in Chicago. These certificates were issued with the knowledge and assistance of the Civil Aeronautics Board.

On the basis of these certificates TWA began taking accelerated depreciation for income tax purposes on the facilities in question, beginning in 1951. Its reports to the Board for the years 1951, 1952 and 1953 showed (a) the actual taxes paid and (b) the amount of taxes deferred by reason of the accelerated depreciation. The aggregate of these two was slightly less than the amount of taxes TWA would have paid if it had not taken the accelerated depreciation.[19] The deferred taxes were treated as an expense on the theory that they constituted a tax liability that would have to be paid.

In determining excess earnings of its domestic division for offset purposes, TWA requested the Board to recognize its treatment of the deferred taxes, i.e., as an expense in the year such deferred taxes accrued. It was TWA's

[19] This was because the deferred taxes were accrued at the rate of 50 percent instead of the current income tax rate of 52 percent.

position that sections 124A or 168 did not authorize forgiveness of taxes but rather only permitted a deferment of taxes..

16787

Thus, the carrier contended that rapid amortization of its defense facilities during the period 1951-1953 resulted in increased liability payable beginning with the year 1956. On this basis TWA argued that the deferred taxes should be allowed as a proper tax expense in determining TWA's level of domestic earnings in the offset period.

To do otherwise would, according to the carrier, nullify the purpose of the Internal Revenue Code and defeat the objective of the Air Coordinating Committee in encouraging air carriers to participate in the accelerated depreciation program. It was pointed out that this treatment did not increase the carrier's total domestic expenses over the level they would have been if the carrier had not taken accelerated depreciation, and that authoritative accountants and the Securities and Exchange Commission have held that deferred taxes of this type are proper charges to expense as proposed by TWA. TWA also pointed out that most regulatory ratemaking agencies have held that provision must be made for meeting deferred taxes by a charge against current earnings.

The Bureau and the Postmaster General took a contrary position. They contended that no provision should be made for deferred taxes in determining the amount of TWA's domestic earnings available for offset. The Bureau reasoned (a) that an allowance of such a nature would be inconsistent with the Board's "actual" tax policy established in *Western Air Lines, Inc., and Inland Airlines, Inc., Mail Rates*,[20] and (b) that an allowance might provide

[20] 14 C.A.B. 201 (1950).

TWA a windfall in the event that the taxes were not paid at a future date when they became due.

16788

Notwithstanding its position against recognition of the deferred taxes, the Bureau agreed with TWA on a form of condition which would eliminate the possibility of a windfall in the event the Board reached the conclusion that the deferred taxes should be allowed. The condition would obligate TWA to repay to the Government any amount of the deferred taxes that are not consumed by the increased taxes in the future as a result of the previous accelerated amortization.

The Board, in a three-two vote, rejected TWA's argument, agreed with the position of the Bureau and the Post Office Department, and found that the deferred taxes should not be recognized as an expense, even with a proviso or condition that it would elminate any possibility of a tax windfall to TWA.

The result of this decision was a disallowance of the deferred tax reserve and an increase in TWA's reported domestic earnings by an equal sum. In turn the carrier's excess earnings for offset against its transatlantic subsidy needs was increased by $2,990,123.

The deciding vote on this issue was cast by the Chairman of the Board who participated earlier in the proceeding as solicitor of the Post Office Department. In that capacity he had signed a brief dealing with the various offset issues including the instant issue. TWA moved to vacate the decision on the grounds that the Chairman was disqualified from participating, but this motion was denied as well as a subsequent motion for reconsideration.

Thereafter, TWA appealed the Board's decision to the U.S. Court of Appeals which, as related earlier, remanded

the case for reconsideration because of the failure of the Chairman to disqualify himself. Pursuant to

16789

the court mandate the Board, in its order reopening this proceeding, directed that the entire issue be reviewed.

Contentions of the Parties. The portions of the briefs of the parties directed to this issue are primarily a reargument and amplification of the positions as noted above. While it would be repetitive to review these arguments, the importance of the issue justified an elaboration of salient points and authorities relied on by the parties.

In urging that its deferred tax reserve be recognized as a proper expense, TWA claims that its position is sustained by authoritative accounting sources and by rate-making practices of the Federal Power Commission as well as the Civil Aeronautics Board.

With reference to accounting sources, it points to documents of record which disclose that Haskins and Sells, Certified Public Accountants in Kansas City, and the American Institute of Accountants agree with TWA's treatment of the deferred taxes under section 124A or its successor section 168. The former, in dealing specifically with the TWA problem under consideration, stated:

> "In our opinion, failure to make a charge against income for the current year to provide for the understatement of Federal income taxes resulting from the deduction of accelerated amortization of emergency facilities would result in an overstatement of income for each of the three years in the amount of the deferred Federal income taxes * * *."

As to the Federal Power Commission, TWA refers to the fact that that agency has consistently recognized accruals for taxes deferred due to

accelerated amortization. In an opinion announcing its policy with respect to the treatment of Federal income taxes for rate purposes under section 124A[21] the Federal Power Commission held that electric public utilities and natural gas companies should accrue reserves equal to taxes deferred under section 124A, and that their rate should not be lowered to reflect the temporary tax savings. The Commission rejected an argument that rates should be reduced during the five-year period of rapid amortization with the following comment:[22]

> "The answer to this contention is that Congress obviously did not intend to make cash donations to the particular persons who happen to be, during the 5-year period of accelerated amortization, the customers of the particular utilities which have received certificates of necessity. Such a result would be inconsistent with the effort of Congress to aid our national defense."

The Commission concluded that by enactment of section 124A Congress did not forgive the payment of any income tax but merely allowed payment of some of them to be deferred. This, according to the Commission, had the precise effect of a grant by our Government to a certificate holder of an interest free loan.

As to the practice of the Civil Aeronautics Board, aside from the present case, TWA points out that, in the *General Passenger Fare Investigation*,[23] the Board recognized accrual for tax purposes under both

---

21 Re: Treatment of Federal Income Taxes as Affected by Accelerated Amortization, 2 PUR 3d 41 (1954).

22 Ibid, page 43.

23 Docket 8008 *et al.*, Order E-1668, decided November 25, 1960.

sections 168 and 167 of the Internal Revenue Code of 1954. The latter is similar to the former in that it permits accelerated amortization for tax purposes instead of normal amortization. It differs from section 168 in that it is not concerned with defense purposes.

The validity of the accruals under section 168 was not questioned by any of the parties including the Bureau. However, the Bureau opposed accruals under section 167 on the theory that the effect of that section was to produce a permanent tax savings for the indefinite future rather than a mere deferral of taxes, and that Congress in enacting section 167 did not intend to modify regulatory practice in ratemaking cases or affect rate policy under the Federal Aviation Act.

The Board rejected the Bureau's position and concluded that "to deny the normalized taxes would be contrary to the clear intent of Congress to grant all tax payers what amounts to an interest free loan in the earlier years of the service life of assets to be repaid in later years." It noted that its decision respecting section 167 was supported by *City of Detroit* v. *Federal Power Commission*.[24] While that case involved section 124A, the Board found that the two statutes had the same basic effect and that their difference in detail did not alter its opinion as to the Congressional intent to confer a benefit on the taxpayer.

Conceding that the *General Passenger Fare Investigation* was a commercial rate case and not a subsidy mail rate case, TWA insists that, in the context of the intent of Congress with respect to section 124A or

---

[24] 230 F. 2d 810 (1955).

section 168, the two types of rate cases cannot be differentiated. The intent of Congress, according to the carrier, has the same effect whether the section is used by a taxpayer applying for a commercial rate or applying for a subsidy.

Even assuming that a distinction can be properly drawn in the application of sections 124A or 168 to a subsidy and nonsubsidy case, TWA insists that its tax accruals in the instant case must be recognized since they were not established with reference to any subsidized operation. They involved TWA's domestic operations which were on a closed or future rate and, according to the carrier, the only issue before the Board is whether such accruals can be properly disallowed and thus added to its reported earnings in determining the excess earnings available for offset.

In further support of its position TWA cites the *City of Detroit* case, *supra*, which as noted, upholds the Board's conclusions in the *General Passenger Fare Investigation*, and the recent Court of Appeals in the *Panhandle Eastern Pipeline Company* v. *Federal Power Commission*,[26] which reaffirmed the *City of Detroit* case.

In the *City of Detroit* case the Federal Power Commission's treatment of deferred taxes arising under section 124A was sustained by the Court. The Court held that it would not disturb the Commission's solution of the

problem created by Federal income tax savings resulting from accelerated amortization. It agreed that the Commission acted properly in rejecting an argument that the savings affected by accelerated amortization should partly

26 Case No. 16,479 United States Court of Appeals for the District of Columbia, decided September 27, 1962.

inure to the benefit of the consumers, and it stated that the Commission correctly included——

> "That the attempt of Congress reflected in Section 124A is not to benefit consumers but rather the tax payer in order to encourage construction of certain emergency type facilities."

In referring to the tax accruals the court said:

> "The funds go into a reserve account for the payment of the deferred taxes to accrue after the five year amortization period. Though thus earmarked, the funds are available for income-producing purposes. Unless this is permitted, it is difficult to see how Panhandle could benefit substantially from section 124A. This statute, unlike the National Gas Act itself, is not for consumer benefit. It has a different public policy and should be given effect as intended by Congress."

The *Panhandle* case, *supra,* involved tax reserves accrued under sections 167 and 168. In that case the Federal Power Commission deviated from the *City of Detroit* case and applied a lower rate of return to the deferred tax reserve in Panhandle's rate base on the theory that the benefits of liberalized depreciation should be divided between the utility and the ratepayer. The court refused to uphold the Commission's action pointing out that, in the *City of Detroit* case, the question of whether temporary income tax savings resulting from accelerated amortization should be divided between the company and the ratepayers was presented and

answered in the negative by both the Commission and the court. The court added:

> "We cannot change the plain purpose of these statutory sections merely because the Commission thinks they have had a 'basically dynamic and fluid effect.' Congress has not provided that, with respect to utilities, ratepayers are entitled to share in the temporary benefits resulting from the use of liberalized depreciation in computing income taxes. Such a provision, which would put utilities and unregulated companies in different categories, may be within the competence of Congress, but neither the Commission nor this court is authorized to legislate in that fashion. Moreover, if it should hereafter provide that utilities must share with their ratepayers the temporary reduction of income taxes produced by liberalized depreciation during the early years of useful life, Congress probably would also provide that ratepayers should proportionately bear the higher income taxes during the later years of the anticipated life of the facilities, when the depreciation deduction for tax purposes is relatively small. This would defeat the purpose of the Commission's present order."

In addition to the above points and authorities TWA notes that every state commission in the country that has considered the question of accrual under section 168, except the North Dakota Commission, has recognized such accruals. While the Interstate Commerce Commission has denied normalization for both accelerated depreciation and rapid amortization its position, according to TWA, has been criticized by the House Committee on Government Operations.

The briefs of the Bureau and the Post Office Department reiterate their position (described above) that recognition of the deferred tax accrual would be contrary to the

Board's actual tax policy in the *Western-Inland Case, supra*, and would provide TWA a windfall in the event the taxes were not paid at some future date.

16795

With reference to the Board's actual tax policy they contend that, in the mail rate period under review, TWA has received an allowance for Federal income taxes which met its actual liability. Since the deferred tax accrual was not paid in the review period, according to the Bureau and the Post Office, it represents an expense which was not incurred and therefore, consistent with the *Western-Inland Case*, must be disallowed. To recognize it, they claim will result in a windfall since the carrier has not as yet paid such taxes and are unlikely to do so in the future.

The Bureau points out that the continued use of the provisions of sections 167 and 168 has enabled TWA to defer Federal income taxes through 1960 and to build tax reserves by that time which total over $13 million. The Bureau further points out that between the time TWA achieved self-sufficiency in 1954 and 1960 it had paid income taxes in only three years, *viz.*, $675,000 in 1954, $1,168,000 in 1959 and $7,519,000 in 1960. However, because of the substantial losses in 1961, the taxes paid in 1959 and 1960 were refunded due to the carry-back provisions of the Internal Revenue Code.

The Bureau also emphasizes that TWA has a loss carried forward for 1961 of approximately $39 million which makes it unlikely that TWA will have any taxable income in the forseeable future. Besides, because of the dynamic growth of the airline industry and the reequipment program of the carriers, including TWA, further deferrals will go on indefinitely, with the result that TWA will be able to perpetuate the tax advantages it achieved

by utilization of section 124A between 1951 and 1953. Thus,

16796

the Bureau argues that TWA's deferred tax accruals are not "deferrals" but are actual savings, and to recognize them as an expense in fixing TWA's 1946-1953 mail rate will give the windfall from the public treasury for an indefinite period.

While the Bureau concedes that section 124A was passed to encourage investment in facilities needed for the national defense, it points out that the Board, in fixing rates under Section 406(b) of the Act, is also required to take into consideration the national defense. Hence, the Bureau questions how TWA can contend that it is entitled to an additional allowance for deferred taxes under section 124A and that the Congressional intent of section 124A has been thwarted.

The Bureau asserts that there is a wide divergence of opinion among Federal and state and regulatory commissions as to how deferred tax accruals should be treated. But regardless of this alleged conflict, the Bureau argues that there is an essential difference between a public utility ratemaking case and a subsidy mail rate case. First, according to the Bureau, none of the public utility ratemaking agencies operate under enabling statutes which provide for subsidy based on the "need" of the carrier for *inter alia* national defense. Secondly, public utility ratemaking as well as the Board's commercial ratemaking involves the fixing of rates for future periods of indefinite duration as opposed to the past period subsidy rates in which most operating results are known. Thirdly, the decisions of the Federal Power Commission and other public utilities which "normalize" consider the problem

of consumer benefits versus company advantages and hold that the company should have the advantage since it will not be prejudicial to the ratepayer, whereas under

16797

a subsidy mail rate the United State Government alone is in the position of the ratepayer, the money comes from the public treasury, and the compensation can be awarded only if a "need" for certain purposes is found. The Government, according to the Bureau, is not in the neutral position of the consumer as in the *City of Detroit* case.

In the final analysis, the Bureau claims that recognition of the deferred tax accrual would give the carrier a subsidy in excess of its need for the 1946-1953 period, and would have the effect of granting a subsidy for a period in which the carrier has attained self-sufficiency. On this premise the Bureau says that the question to be decided here is whether the Board, having provided for TWA's actual need, is also required to underwrite with subsidy the deferred tax accrual which, if payable at all, will be dispersed at a time when the carrier has no need for subsidy.

• • • •

16798

THE CAPITALIZED INTEREST ISSUE

During the period under review TWA maintained substantial advance deposits with certain aircraft manufacturers pursuant to contract for purchase of aircraft. Under the Board's ratemaking practices these deposits are excluded from the carrier's rate base, but the Board permits capitalization of constructive interest on them to be amortized over the service life of the aircraft involved.

(16798, 16799)

At the time of the Board's original opinion in this case dealing with the transatlantic phase[31] it was the practice to compute the amount of interest on the deposits in the following manner:

(a) To the extent the deposits were not in excess of carrier's total debt, by applying the average interest rate paid by the carrier on its outstanding debt to the amount of the deposit; and

(b) To the extent the deposits exceeded total debt, by applying a 5-percent rate to the excess.

This formula had been in use since the 1947 decision in *Pan Am Airways, Inc., Transatlantic Mail Rate Case,* 8 C.A.B. 267.

In deciding the transatlantic phase the Board accepted an agreement of Bureau Counsel and TWA that allowed a claim of $373,289 for capitalized interest. However, while petitions for reconsideration were pending and after the offset proceeding had been instituted Bureau Counsel discovered

16799

that this allowance was predicated on a five-percent rate, whereas, under the Board's accepted formula (average interest rate on outstanding debt), the allowance should have been computed at a 3.1-percent rate. He therefore requested the Board to reduce the allowance accordingly, but in order to avoid the possibility of inconsistent findings on the issue in the transatlantic and offset phases he suggested that the capitalized interest problem should be handled in the latter phase.

However, notwithstanding this suggestion the Board issued an opinion finding that TWA's mail pay should be adjusted to reflect a reduction in capitalized interest from five-percent to the level actually incurred.

---

31 19 C.A.B. 475 (1954).

Meanwhile, in the offset phase, this issue was considered by the Examiner so far as it concerned TWA's domestic division, and in his Initial Decision he found that, where it was established that the source of the equipment deposit was equity funds, the amount capitalized should be computed at the equity rate of five percent. The Board adopted the Examiner's Decision, pointing out that the old formula was developed in the immediate post-World War II period under far different circumstances than prevailed in the industry at that time. The Board concluded that recognition of the actual source of the equipment deposits was logically consistent with the objectives stated in *Transatlantic Case, supra,* of recognizing the higher cost of equity capital.

Aware of its different treatment of the problem in the transatlantic and offset phases the Board decided to reconsider it in its order reopening this proceeding. Thus, it directed a determination of what is the

proper amount to be allowed for capitalized interest on equipment purchase funds.

The Bureau takes the position that an additional allowance based on a rate of five-percent is the most equitable course in the light of the Board's decision in the offset phase. TWA agrees and a stipulation was entered into agreeing that the additional allowance should be $218,591.

That the source of TWA's equipment purchase deposits concerned with the transatlantic phase can be traced to equity funds is not disputed. On this basis and in the light of the offset ruling the proper amount for capitalized interest should be determined at the five-percent equity rate. Accordingly, it is found that an additional allowance of $218,591 should be made for capitalized interest.

• • • •

APPENDIX B

Reopened Transatlantic Final Mail Rate Case
Trans World Airlines—International Division
Summary of Total Mail Pay
(In thousands)

	Board's Previous Decision[1]	Adjustments Per This Decision	This Decision
International break-even need	$31,845	$ 983	$32,828
International return on investment at 7%	15,495	177	15,672
Domestic earnings available for offset	—4,183	1,324	—2,859
International income taxes paid	4,025	—	4,025
Total mail pay before income taxes related to excess mail pay	$47,182	$2,484	$49,666
Temporary mail pay received	51,095	310[3]	50,785
Additional or excess (—) mail pay before related income taxes	$—3,913	$2,794	$—1,119
Income taxes related to excess mail pay	—4,240[2]		—1,033[4]
Additional or excess (—) mail pay	—8,153		—2,152
Total mail pay	$42,942		$48,633

1 Order E-10176, dated April 9, 1956.

2 Tax reduction at effective 1956 tax rate of 52%.

3 Post Office Department records show TWA has received $50,784,719 in temporary mail pay, which is $310,281 less than the amount shown in Order E-10176.

4 Tax reduction at effective 1965 tax rate of 48%.

(16802)

APPENDIX C

Reopened Transatlantic Final Mail Rate Case

Trans World Airlines, Inc.—International Division

International Break-even Need

Adjustments Per This Decision
(In thousands)

1.	Reversal of disallowance of 1946 pilot strike loss	$582
2.	Reversal of disallowance of loss due to first four days of navigators' strike	334
3.	Increased capitalized interest on equipment purchase deposits resulting from use of 5% equity capital rate rather than actual interest rate	67
	Total break-even need adjustment	$983

Appendix D

Reopened Transatlantic Final Mail Rate Case

Trans World Airlines, Inc.—International Division

International Return on Investment at 7%

Adjustments Per this Decision

(In thousands)

1. Return on increase in working capital resulting from additional mail pay	$64
2. Return resulting from reversal of strike disallowances:	
(a) Pilots' strike	74
(b) Navigators' strike	14
3. Return resulting from increased capitalized interest on equipment purchase funds caused by use of 5% equity capital rate rather than actual interest rate	25
Total Return on Investment Adjustment	$177

16804

Appendix E

Reopened Transatlantic Final Mail Rate Case

Trans World Airlines, Inc.—International Division

Earnings of Domestic Division for Offset Against International Division Mail Pay

Adjustments Per this Decision
(In thousands)

1.	Reversal of disallowance of 1946 pilots' strike	$1,130
2.	8% return on increased working capital allocated to domestic division as a result of additional international division mail pay, increased because of reversal of strike disallowance	188
3.	8% return on increased capitalized interest on equipment purchase funds resulting from use of 5% equity capital rate rather than actual interest rate	6
	Total domestic earnings for offset adjustment	$1,324

Appendix F

Reopened Transatlantic Final Mail Rate Case

Trans World Airlines, Inc.—International Division

Administrative Allocation of Mail Pay

Period	Amount
Semi-Annually:	
February 5-June 30, 1946	$ 6,621,401
Second half 1946	8,345,599
First half 1947	7,274,765
Second half 1947	7,274,766
First half 1948	1,078,868*
Second half 1948	1,257,624*
First half 1949	1,263,749*
Second half 1949	1,286,563*
First half 1950	1,277,492*
Second half 1950	1,561,479*
First half 1951	1,698,214*
Second half 1951	1,872,442*
First half 1952	1,804,219*
Second half 1952	1,803,145*
First half 1953	1,962,000*
Third quarter 1953	887,000*
Monthly:	
October 1953	331,145*
November 1953	343,790*
December 1953	688,739*
Total	$48,633,000

* Equivalent to service rate of 85 cents times the monthly U.S. mail ton-miles.

12958

E–8833

UNITED STATES OF AMERICA

CIVIL AERONAUTICS BOARD

WASHINGTON, D. C.

Docket No. 1706 et al:

TRANSATLANTIC FINAL MAIL RATE CASE

Decided: December 20, 1954

The fair and reasonable mail pay for American Overseas Airlines for the period January 1, 1946, to September 25, 1950, is $22,107,000, an increase of $4,792,000, over amounts received pursuant to temporary rate orders.

The fair and reasonable mail pay for Trans World Airlines, Inc., for the period February 5, 1946, to December 31, 1953, for its International Operations, exclusive of adjustments which may be required under the Chicago and Southern decision of the Supreme Court, is $50,730,000, a decrease of $365,000 over amounts received pursuant to temporary rate orders.

The fair and reasonable mail pay for Pan American World Airways, Inc., for the period January 1, 1946 to December 31, 1953, for its Atlantic Division Operations, exclusive of adjustments which may be required under the Chicago and Southern decision of the Supreme Court, is $90,469,000, an increase of $6,810,000, over amounts received pursuant to temporary rate order.

The fair and reasonable mail pay for Trans World Airlines, Inc., for the period beginning January 1, 1954

(12958, 12959, 12961)

for its International Operations, exclusive of adjustments which may be required under the Chicago and Southern decision of the Supreme Court, is $4,281,000 per year.

The fair and reasonable mail pay for Pan American World Airways, Inc., for the period beginning January 1, 1954, for its Atlantic Division Operations, exclusive of adjustments which may be required under the Chicago and Southern decision of the Supreme Court, is $8,151,000 per year.

APPEARANCES:

HENRY J. FRIENDLY, ELIHU SCHOTT, JOHN SLATE and ROBERT M. DYER for American Overseas Airlines, Inc., and Pan American World Airways, Inc.

GEORGE A. SPATER, CARL S. ROWE and NAN C. SOWERWINE for Trans World Airlines, Inc.

ROY C. FRANK and EUGENE J. BRAHM for the Postmaster General.

12959

HARDY K. MACLAY and WALTER D. HANSEN for Seaboard & Western Airlines, Inc.

MILTON H. SHAPIRO and ARTHUR H. SIMMS for the Bureau of Air Operation, Civil Aeronautics Board.

12961

Opinion

By the Board:

This proceeding is concerned with the determination of fair and reasonable rates for the carriage of mail in transatlantic operations by American Overseas Airlines,

Inc., Trans World Airlines, Inc., and Pan American World Airways, Inc. The rates to be established are for past period operations dating back to the year 1946, as well as for prospective periods of operation.

The Board on September 29, 1954, issued an opinion herein relating solely to the question of the extent to which divisions of Trans World and Pan American operating in areas other than the transatlantic may have produced "excess" earnings which may be offset against subsidy requirements for transatlantic service.[1] The Board reopened the record for further hearing in order to determine the excess earnings, if any, available for offset purposes. However, it was pointed out that we would proceed with decision on the other issues in this proceeding without further delay. This opinion, therefore, will deal with those other issues. Certain of those issues were adequately treated by the Examiner, and we are therefore attaching hereto as Appendix A, those portions of the Examiner's Initial Decision with which we agree and adopt as our own.[1a] We shall discuss herein principally those issues upon which our conclusions differ from those of the Examiner.

Before turning to the particular issues, we wish to point out that we have been substantially assisted in reaching our decisions on the issues before us by the fact that the record which has been developed takes full advantage of the comparative techniques made possible by our earlier action in consolidating for hearing the mail rate cases of

the three transatlantic carriers. While the time for disposition of the consolidated proceeding has been greater

---

1 Order No. E-8672.

1a It is to be noted that where the opinion uses different figures than appear in the Initial Decision, the Board has based its decision upon the former rather than the latter.

than we originally contemplated, the results have clearly vindicated the soundness of our decision to hold a consolidated proceeding. As will be evident hereinafter, we have taken full advantage of the opportunity afforded to use the "yardstick" technique to evaluate the performance of the United States carriers in the transatlantic area. Without the benefit of each carrier's participation in the case as an adversary in connection with the other's claims and the full record which such participation made possible, we doubt whether we would have been able to utilize fully this comparative approach.

We turn now to a consideration of the parties' contentions.

American Overseas

The Examiner found that this carrier should receive a total of $23,213,000 in mail compensation for its operations for the period January 1, 1946, to September 15, 1950. Bureau Counsel recommended that the Board allow the carrier $22,090,000. AOA seeks an increase of $356,000 over the breakeven need recognized by the Examiner and, in addition, an increase in the 7 per cent return on investment which he allowed.[2]

The principal issues in dispute between the carrier and Bureau Counsel include questions relating to (a) whether the Board should underwrite losses due to a pilots' strike

---

2 The Examiner, adopted Bureau Counsel's contention, that two of AOA's eight Boeing B-377 were not used and useful in its operations and should therefore be treated as excess. Bureau Counsel now takes the position that all eight of the Boeings were used and useful, but were underutilized by the carrier. The record indicates as Bureau Counsel concedes, that AOA could not have met the services it scheduled without all eight of the Boeings. There is no doubt, however, that AOA did not achieve the measure of utilization of its aircraft required by economical and efficient management and therefore, the eight must be treated as underutilized. (Appendix A, pp. 6-9). The effect of treating the aircraft as underutilized rather than excess is to reverse the disallowance for full insurance expense and make an allowance for capitalized interest and to capitalize hull insurance expense.

in the Fall of 1947, (b) the extent to which the Board should recognize for mail pay purposes selling expenses incurred in 1949,[3] and (c) the recognition of certain under-collections of published tariff charges.

Pilots' Strike[4]

AOA's pilots were on strike in the fall of 1947, during which period AOA suffered losses which Bureau Counsel calculated at $598,000. The Examiner concluded that the Board should recognize strike losses as a proper business expense, but that the Board should deny the carrier a return on investment during the strike period and should suspend its depreciation accounts and the amortization of of capitalized interest. In reaching this conclusion, the Examiner asserted (1) that the Board has reversed its previous policy (as exemplified by its changed position on aircraft grounding costs) of requiring the costs of abnormal risks such as a strike to be met out of the return on investment, and (2) that the established past period rate of return on investment is inadequate to compensate a carrier for risks of the size of strike losses.

AOA and TWA, while willing to accept the Examiner's ultimate conclusion, contend that the Examiner erred in finding that it was unnecessary to assess responsibility for the strike. They assert that whether the Board should allow expenses during a strike should be governed by the same tests as other expenses, namely, whether they were incurred under honest, economical and efficient management. The carriers also argue that a disallowance of all expenses during a strike would be giving the unions " * * *

3 This issue will be discussed *infra* at pages 36-40.

4 Appendix A, pp. 9-12, 36. TWA has the same problem as AOA since its pilots were on strike in 1946. This discussion will therefore deal with TWA's as well as AOA's contentions.

carte blanche in writing their own employment contracts and would greatly increase the cost of doing business for airlines."

The Air Line Pilots Association opposes any recognition of strike costs.

12964

It contends (1) that the issue of responsibility for the strike is not practically justiciable; (2) that underwriting strike losses with subsidy "• • • throws the weight of our Federal Treasury into the fray on the side of the company"; and (3) that the Examiner erred in concluding that strike losses should be treated like aircraft grounding costs and recognized as proper expenses. Bureau Counsel also oppose recognition of any losses due to the strike. They take issue with the Examiner's findings and strongly controvert the contentions of the carriers.

We agree with the Examiner only insofar as he found that the Board should not attempt to assess fault for a strike, or intervene therein on the side of management or labor. There is nothing in the language of our statute which requires that we provide a carrier with subsidy for losses due to a failure to provide the service for which it was certificated. Nor do we see any useful public purpose which would be served by the underwriting by the Federal Government of losses occasioned by a labor dispute. It is, we think, a basic tenet of fair government policy that there be no partisan intervention in a labor controversy and that, except where otherwise required by the public welfare, the resolution of differences between management and labor be left to the parties. Obviously, were we to insulate the carriers from the financial loss of a strike, we would deprive labor of its most significant economic weapon and weigh the scales heavily on management's side. Nor do we fear that our refusal to pay strike

losses will necessarily tip the scales in labor's favor or lead to unwarranted subsidy increases. Contrary to the carrier's assertion, it will continue to be in the carrier's economic self-interest to refuse unjustifiable wage demands Even for those carriers which have not yet achieved economic self-sufficiency, there will be a

12965

drive to minimize expenses to render attainable that objective, as well as the desire for competitive reasons to maintain labor expense parity with other industry units which have already achieved this goal. Thus, we think it evident that sound public policy requires that we refuse to underwrite losses attributable to a labor controversy without regard to responsibility thereof.[4a]

In addition, it has been pointed out that it is not customary public utility rate practice to make provision for a strike loss. Since the Civil Aeronautics Act incorporates public utility rate concepts,[5] we should be reluctant to provide reimbursement for strike losses.

It should also be noted that the Examiner, in concluding

4a In this connection, we note that it is easy to be misled, by what appears in the record in this case, into the conclusion that we could readily determine the immediate responsibility in other instances for a work stoppage. However, even were this the case, it would not resolve the problem. Any such limited inquiry would be entirely too superficial to satisfy the statutory obligation relating to appraisal of economical and efficient management. Thus, for example, while labor in a given instance may bear a greater responsibility than management for the immediate work stoppage, we could not stop our inquiry with this conclusion and assume financial responsibility for strike losses. We would have to go further and determine whether management had conducted its overall relationships with its employees in an economical and efficient manner, since it is apparent that a work stoppage is only one overt act in the course of labor-management relations in which prior history plays a significant part. However, such an inquiry is not only beyond the scope of our expertise, but there are other substantial objections to our undertaking such a task. Thus, we would have to embark on what may often be an extremely complex and difficult investigation, which may seriously impede the expeditious discharge of our primary rate function. And we would have to do this in many instances without having the benefit of a fully litigated record on such subject, which could only be assured in a labor forum in which the full interest of the employees would be engaged.

5 *Transcontinental and Western Air.* v. *C.A.B.*, 336 U.S. 601 (1949).

that strike losses should be underwritten, erred in relying upon the premise that we have reversed our general policy with respect to requiring abnormal risks which are neither predictable nor measurable to be met out of return on investment. We have not reversed that general policy. It is true that in the *American Airlines et al., Mail Rate*

Case[6] we found that aircraft grounding costs, which in the *Braniff Case*[7] we had refused to underwrite, should be capitalized and amortized. However, we expressly recognized that this action constituted an exception to our general policy. In that instance, we found the exception warranted by the public interest in order not ". . . to discourage carriers in developing new aircraft type"; such discouragement, we further pointed out, would be ". . . inconsistent with our statutory obligation to develop a sound air transportation system".[8] Since strike losses are clearly not developmental in nature, the rationale of the *American Airlines Mail Rate Case* is inapplicable. Nor have the carriers advanced any other substantial public purpose which would be served by the underwriting of strike losses.[9] There is therefore no reason for depart-

6 10 C.A.B. 341 (1949).

7 9 C.A.B. 607 (1948).

8 10 C.A.B. 341, 345.

9 Also compare our action in this case recognizing certain TWA flood losses as an expense in the year incurred rather than crediting the carrier with a self-insurance reserve. See pages 30-31 *infra*. As we later point out, to do otherwise might result in the bankruptcy of a carrier and termination of a useful public service as a result of a risk for which management could make no reasonable provision. Such a result we believe would be contrary to the public interest. We find no similar public interest which would warrant our underwriting strike losses. It has been similarly suggested that our decision refusing to underwrite strike losses may expose a carrier to comparable irreparable financial injury as a result of a strike which occurred without fault of management. While such a result is theoretically conceivable, we do not regard it as a practical possibility. We may point to the empirical fact that in more than 15 years of regulated experience, there has been no strike of such debilitating proportions in the industry.

ing from our general policy with respect to requiring abnormal risks which are neither measurable nor predictable to be met out of the return on investment.

In this regard, we cannot accept the Examiner's conclusion that the established 7 percent rate of return for mail rates set retroactively is inadequate to cover strike losses. The basic error underlying the Examiner's conclusion was his failure to distinguish between the risk of a strike, and the loss occasioned thereby. There has been no demonstration in the record that, viewed on an industry wide basis, the strike risk is anything

but a relatively small one, and it is certainly considerably smaller than the quantitative measure used by the Examiner.[11] Thus, it has not been shown that the risk of strike loss represents more than a negligible part of the established 7 percent rate of return on investment for past period operations, or that the 7 percent return is inadequate to cover such risks.[12]

We also take note of the fact that AOA has challenged Bureau Counsel's technique for costing strike results, contending that its losses during this period should be confined to its increased breakeven need plus a return on its investment for the strike period. This would reduce Bureau Counsel's proposed disallowance from $598,000 to $363,000. Bureau Counsel has followed the costing method we originally proposed for AOA in 1949.[13] We then stated and here reaffirm the conclusion that the soundest

11 Thus, the Examiner, in effect, assumed that AOA would have a pilots' strike once every four years—whereas in the entire history of the industry, including the recent American Airlines' strike, there have been relatively few strikes.

12 Braniff Airways, Inc., Domestic Operations, Mail Rates, Order No. E-7780, dated October 1, 1953, p. 8, finalized by Order No. E-7928, dated November 27, 1953.

13 Order No. E-2731, dated April 19, 1949. It is to be noted that TWA has not challenged Bureau Counsel's method of costing the strike.

measure of a loss due to a strike is the excess of mail pay that is required on the basis of actual operating results for the strike year over the mail pay that would have been required had the strike not occurred. The latter figure is computed by estimating the mileage and revenue lost and the expenses saved during the strike, using these figures to compute a normal mail pay requirement for the year, and applying the resulting rate per plane mile to the miles actually flown during the strike year.

Briefly, the difference between the two methods of costing the strike is that under Bureau Counsel's method the cost of the strike includes not only the net non-U.S. mail revenues lost as a result of the strike but also the "normal" U. S. mail pay lost by reason of the carrier's failure to

perform service during the strike period, whereas under AOA's method the cost of the strike would be limited to the net non-U. S. mail revenues lost plus a return element computed on a time basis. The inclusion of lost U. S. mail pay in the cost of the strike is an adjustment which follows from the method of computing the normal mail pay to which the carrier would be entitled for the service actually performed during the strike year. This method of determining the normal mail pay requirements for the period of actual operations is consistent with the concept that mail payments for a period of less than one year should be computed on the basis of rates per unit of service representative of at least a full year's operation, and not upon a cost-plus basis for the particular fractional period.[14]

AOA's method assumes that the "cost" of the strike is

14 Colonial Airlines, Inc., Domestic System Mail Rates, Order No. E-5777, October 9, 1951; Braniff Airways, Inc., Mail Rates, 11 C.A.B. 431 (1950); American Airlines, Inc., Mail Rates, 3 C.A.B. 323 (1942).

merely the difference in need as actually experienced during the strike period and the need that the carrier would have experienced had there been no strike, plus a small return element. While this method would appear to be plausible at first glance, it has the effect, as is hereinafter indicated, of burdening the rate for the remaining period of the year.

For example, had AOA's strike not occurred, Bureau Counsel estimate that under normal conditions the carrier would have performed 7,785,000 revenue plane miles during 1947 and would have required total mail pay of $5,053,000 or 64.91 cents per plane mile. However, as a result of the strike, the carrier flew only 7,343,000 miles and on the basis of its recognized expense and revenues would require total mail pay of $5,364,000 to meet its

12969

breakeven need and to provide a return on investment. If from the latter figure we deduct merely the amount of breakeven need and return on investment[15] attributable to the strike ($363,000), the resultant cost to the Government for 1947 would be $5,001,000, or 68.11 cents for each revenue plane mile actually flown, as compared with the 64.91-cent rate which would have been paid had there been no strike. The additional cost of 3.20 cents per plane mile is a direct result of the strike, according to Bureau Counsel, and should be eliminated if the Board is to adhere to sound rate-making principles.

We find substantial merit in Bureau Counsel's approach. It is clear that the net effect of following the carrier's method of costing the strike is to increase the unit rate for service during the balance of the year. Thus, the rate payer has, in effect, been compelled to pay for service which was not rendered. However, in one minor respect

15 Return on investment has been computed on the basis used by AOA, that is $18,365 or 4.93% of the return for the full year 1947.

we believe that Bureau Counsel may have overstated the cost of the strike. Bureau Counsel included in the unit rate an element for return on investment, which TWA properly notes, we ordinarily fix on a time basis. The effect of this is to overstate the cost of the strike by $8,000. We shall, therefore, readjust the strike costs as set by Bureau Counsel to reduce the loss of return on investment by $8,000. With this adjustment, the strike loss for AOA is $590,000 which we have disallowed.

Undercollections[16]

The Examiner found that both AOA and PAA's rates of undercollections, i.e.,

12970

their failure through error to collect the full amount called for by applicable tariffs, were unreasonable, by comparison with TWA's experience, and that a substantial proportion thereof should be excluded in fixing the carrier's rate. The Examiner also found that overcollections (the converse of undercollections) should be treated as "other revenue" and so applied as to reduce the carrier's subsidy need.

Bureau Counsel support the Examiner's conclusion. AOA and PAA contend that undercollections are inevitable in view of the complexity and difficulty in computing fares and charges, and that disallowance should not be made without identification of the areas in which carrier inefficiency resulted in excessive undercollections. The carriers contend that TWA is not an adequate yardstick in view of its alleged poor bookkeeping and auditing practices. Moreover, they contend that since a reasonable volume of overcollections is also inevitable, overcollections should be offset against undercollections.

16 Appendix A, pp. 12-15, 39, 72.

After consideration of the carrier's contentions, we have adopted the Examiner's conclusion as our own. AOA and PAA's assertion that their higher rate of undercollections stems from superior auditing and bookkeeping practices is not supported by the record. Moreover, in our judgment the extent to which the Board should underwrite losses due to undercollections should be strictly limited. It would be unsound public policy to underwrite with subsidy payments unwarranted losses stemming from a failure to collect the full measure of commercial revenues called for by a carrier's tariffs. By the same token, we would not wish to place any premium upon the collection of higher sums than called for by such tariffs; this inevitably would be the case were such sums to be considered as anything other than amounts to

12971

be used to reduce subsidy need.

Deutschemark Reserve[17]

One further matter with respect to the determination of AOA's mail rate bears mention. This relates to a controversy between the Post Office Department and AOA as to whether the proper accounting procedure was followed with respect to a special Deutschemark reserve account which we authorized AOA to establish.[18]

It is conceded that the decision turns upon a proper interpretation of our order. We have considered the contentions of the parties, and have concluded that the Initial Decision correctly interprets our order. Thus, contrary to the Post Office's contention, there was a substantial portion of the accumulated deutschemarks in the special re-

17 Appendix A, pp. 21-22.

18 Order No. E-2731, dated April 19, 1949, pp. 25-38. It is conceded that AOA will not be out-of-pocket whether or not the Post Office position is sustained.

serve account when the currency was devaluated on September 1, 1949, and the carrier suffered a loss which is properly chargeable to such account.

Based upon the foregoing considerations and all the facts of record, we find that AOA should be allowed mail pay as set forth below:

Breakeven need	$14,128,000
Return on investment[19]	5,005,000
Provision for Federal income tax	2,974,000
Total	$22,107,000

12972

Past Period Mail Rates for TWA and PAA

For reasons hereinafter set forth (pages 96-100, *infra*) we have decided to treat the year 1953 as part of the past period and to start the future period rate on January 1, 1954. Since data for the year 1953 was not available at the hearing, we are required to apply to reported data for 1953 the rate principles established herein on the basis of data for prior years. We recognize that, in the application of such principles to the reported 1953 data without hearing, the carriers may feel that we have misstated their mail rate requirements. Nevertheless, we have decided to proceed without delay to a decision on this matter in

---

19 AOA raised two questions in connection with this item. First, it sought equal treatment with TWA with respect to working capital—seeking more than three months cash operating expenses if TWA were allowed such an amount of working capital. Such provision is not being made for TWA (see pages 46-48, *infra*). AOA also requests a higher than 7 percent rate of return on investment for operations during an open rate period. We agree with the Examiner, however that a higher than 7 percent rate is not warranted (see Appendix A, pp. 97-98).

order to expedite an early conclusion to this proceeding, an objective sought by all concerned.[20] However, if this procedure inadvertently produces unfair results for either TWA or PAA, the carrier would, of course, have the right to seek such further proceedings as it may deem necessary to present its views.

The Rate for TWA for the Period February 5, 1946 to December 31, 1953

The Examiner found that TWA should receive $32,975,000 in breakeven need for the period 1946-1952. Bureau Counsel in their brief to the Board recommend that TWA receive $32,186,000 in breakeven need for the year longer period 1946-1953. TWA's contentions would, if fully recognized, result in as much as 6 million dollars more breakeven mail pay than recommended by the Examiner. There is set forth below our decision on the matters in issue between the parties.

12973

TWA—Reallocation of Common Costs

We are here concerned with the question of whether TWA may properly be permitted in this proceeding to adjust its reported costs and revenues by revising its previously established bases of allocating such items between its domestic and international divisions in such

[20] Subsequent to oral argument before the Board in which TWA called attention to certain alleged errors in the mail pay proposed for TWA for the year 1953 in Bureau Counsel's brief to the Board, Bureau Counsel filed a letter making adjustments to the figures proposed in its brief. TWA has not filed an answer to Bureau Counsel's letter. Our calculations of TWA's mail pay requirements have therefore, insofar as our decision herein adopts Bureau Counsel's contentions, been based upon the revised figures.

manner as to increase the net profits of the former and the subsidy requirements of the latter. This issue was not resolved in the Initial Decision, since the Examiner concluded that the Supreme Court's decision in *Summerfield* vs. *C.A.B.*,[21] rendered the issue moot.[22]

Bureau Counsel and TWA, however, agree that on the basis of the decision we reached on the offset issue,[23] we must at least determine whether the carrier will be permitted to reallocate expenses and revenues between its domestic and international divisions for the 1947-1950 period for which we set a past period rate for TWA's domestic division.[24] The reallocations proposed by TWA would result in increasing the break-even need of the international division in this period by $1,038,201. In addition, it may be pointed out that if we determine, after conclusion of the further proceedings we have ordered on the offset issue,[25] that the domestic division does not in the 1946-1947, or 1951-1953 periods have excess earnings available for offset purposes the question of reallocation of expenses between the two divisions during these periods may not be moot. We shall, therefore consider the reallocations proposed for the entire period 1946-1952 which would have the net effect of increasing TWA's international division need by $2,816,323.

12974

TWA's reallocation proposals are based upon accounting adjustments made by the carrier in its year-end Form 41 report for 1951, filed with the Board in April

---

21 347 U.S. 74 (1954).

22 The Examiner concluded that the decision turned a final rate order for one division of a multi-division carrier into a temporary rate order which could be raised or lowered, as the case may be, after further review, in setting the rate for other divisions.

23 Order Serial No. E-8672, *supra*.

24 American Airlines, Inc., *et al.*, Mail Rates, 14 CAB 558 (1951).

25 Order Serial No. E-8672, *supra*.

1952. In this document TWA reported certain data for its international and domestic operations on the basis of different criteria than it had previously used for distributing joint costs (and certain revenues) between its domestic and international divisions. The net result of these revised allocations was to shift a greater portion of such costs from the domestic to the international division,[26] It is conceded that the greater part of the reallocations made in such report is on an acceptable basis for distributing costs between TWA's domestic and international divisions for the last quarter of 1951 and periods subsequent thereto. However, TWA in this proceeding has taken the position that the Board should recognize adjustments of a similar nature for the prior years dating back to 1946.

For legal and policy reasons, Bureau Counsel would deny all retroactive reallocations between divisions. Bureau Counsel point out that during the period prior to 1951, TWA's domestic division was on a final mail rate[27] while the rate of the international division was open. Bureau Counsel characterize the reallocations as being under a shadow, since with the domestic division on final mail rates, the carrier has an incentive to maximize domestic

profits.[28] Bureau Counsel do not purport to hold the carrier to a standard of perfection in the maintenance of

---

26 TWA did not call attention in such reports to the fact that it considered its previous allocations to have been in error and that it believed it had overstated its domestic and understated its international expenses. Nor did the carrier then request permission to revise retroactively these reports which it had already made which were based upon different methods of allocation.

27 Prior to March 14, 1947, the carrier's domestic division was on a service rate set prospectively. From March 14, 1947 through December 31, 1950, it was on a subsidy rate for a past period. Thereafter, it was on a future period service rate.

28 Bureau Counsel refer to the timing of TWA's reallocations, noting that they were not filed until after conclusion of the Big Four Case although admittedly they were under discussion within the carrier's organ-

its accounts, but rather seek to minimize the incentive that would be afforded by the carrier's knowledge that it could reallocate expenses between divisions once its purpose has been served in a particular proceeding so that it might in a subsequent proceeding take advantage again of the data in its records.

It is further charged that TWA has lagged unjustifiably in making efforts to correct its accounts and that it failed originally to exercise that degree of care in maintaining its accounts which would have avoided the present situation. Thus, it is to be noted that while TWA asserted, in view of the novelty and difficulty of the allocation problem, that it reviewed its allocation procedures from time to time, it did not file reports based upon the reallocations in question until five years after it started operations. In addition, some of the adjustments sought by TWA, allegedly stem from the failure of TWA employees over a considerable period to follow the carrier's own prescribed procedures. On these facts, the contention is made that TWA should not be allowed to profit by its own accounting deficiencies.

12976

Bureau Counsel cite accounting instructions of the Board to all air carriers prohibiting retroactive revisions which would capitalize and amortize costs which were previously reported as expenses, and decisions which have refused to permit revision of depreciation rates reported during a closed rate period, as establishing Board policy

---

ization during the course of that proceeding. Bureau Counsel call attention to the fact that it was not until after the personnel responsible for prosecution of TWA's mail rate cases had conferred with TWA's controller and the latter had realized "desired objectives" that the reallocation bases were changed. The changes, as previously pointed out, had the net effect of increasing TWA's profits under its service mail rate for the domestic division and increasing the subsidy requirements of the international division.

against reallocations such as are here proposed.[29] Numerous decisions of courts and other regulatory bodies were also cited as holding against the propriety of retroactive accounting adjustments by industries subject to rate regulation.[30] Finally, Bureau Counsel assert that the Form 41's of TWA as well as those of the other carriers in the *Big Four Case* were stipulated into the record by the parties, that the Board had before it, and gave consideration in that case to the very expenses which TWA now seeks to reallocate from the domestic division to the international division for consideration again in this proceeding.

TWA takes issue with Bureau Counsel's position. TWA contends that in the early period of international division operations, it had no experience in allocating costs between its international and domestic divisions, and that its later experience proved that its earlier allocation bases were faulty resulting in undercharges to the international division and overcharges to the domestic. The carrier argues first that the Board in the only previously decided final mail rate cases involving questions of allocations between domestic and international divisions,

12977

considered and approved substantial revisions of data as reported.[31] TWA asserts that both Board and general

---

29 Standard Practice Letter No. 8, October 22, 1952. American Airlines, Inc., et al., Mail Rates, 14 C.A.B. 558 (1951); Braniff Airways, Inc., Mail Rates 9 C.A.B. 607 (1948); Chicago & Southern Air Lines, Inc., Mail Rates, 9 C.A.B. 786 (1948); Delta Air Lines, Inc., Mail Rates, 9 C.A.B. 645 (1948)

30 E. G., Colorado Interstate Gas Co., vs. Federal Power Commission, 142 F (2) 943 (C.C.A. 10, 1944) aff'd. 324 U.S. 581 (1945); Knoxville vs. Water Co. 212 U.S. 1 (1909); Re Cities Service Gas Co., 50 P.U.R. (NS) 65 (F.P.C. 1943) aff'd. 155 F (2) 694 (C.C.A. 10, 1946), cert. denied 329 U.S. 773 (1946).

31 Northwest Airlines, Mail Rates (Domestic), Order No. E-5839, dated November 2, 1951, made final by Order E-6338, dated April 18, 1952; Northwest Airlines, Inc., Mail Rates (International), Order No. E-5838, dated November 2, 1951, made final by Order No. E-7079, dated January 13, 1953; Chicago and Southern Air Lines, Inc., Mail Rates (Domestic), 9 C.A.B. 786 (1948); Chicago and Southern Air Lines, Inc., Mail Rates (International), Order No. E-5385, dated May 18, 1951, finalized in 14 C.A.B. 681 (1951).

public utility policy barring retroactive revisions of accounts has as its sole purpose—the avoidance of double compensation for the regulated utility for any expenditure. On this point, TWA submits that it will not receive double compensation if the reallocation is recognized herein because the domestic rate set in the *Big Four Case* was a class rate which resulted in a return to TWA of only 2.9 percent for the 1947-1950 period. The allowance of the reallocations sought would, according to TWA, serve only to increase that return to approximately four percent, which is below the amounts realized by the other carriers in that proceeding. TWA further argues that it derived no advantage in other Board proceedings from its overstatement of domestic and understatement of international break-even need. TWA also contends that it was not silent with respect to the allocation problem until after decision in the domestic rate case but, on the contrary, raised questions with respect to certain allocations and requested concurrent consideration of its domestic and international rates.[32] TWA asserts that while it agreed to accept the rates proposed in the *Big Four Case,* it expressly reserved the

12978

right to contest the underlying findings of the Board in that case.

It may serve to place the problem before us in perspec-

[32] It is to be noted that Bureau Counsel has proposed that we recognize the reallocations proposed by TWA to the extent of $531,968, on items of which the carrier had given specific notice in the course of the Big Four Case. Thus Bureau Counsel has proposed recognition of certain overhaul expenses incurred in aircraft operated in the international division and later transferred to the domestic division. In addition, Bureau Counsel has proposed recognition of certain sales expenses related to the sale of foreign transportation through domestic sales agents where TWA erroneously failed to charge the international division with the costs incurred in ticketing. However, in connection with the latter item Bureau Counsel in our judgment have gone too far. Thus, they propose recognition of the reallocated expense prior to March 14, 1947, the date on which TWA opened the domestic division rate. In our judgment, recognition of the proposed reallocations should be limited to the period when both the international and the domestic divisions were on open rates. See pp. 20-21, *infra.* This would reduce the recognition of reallocations proposed by TWA as previously indicated to $449,000.

tive to outline briefly the general nature of the accounting adjustments with which we are concerned. For the most part, we are not here dealing with errors of a mathematical or clerical type, but rather with a change in management's judgment as to what criteria should be used to prorate expenses jointly incurred for operations of the domestic and international divisions. Such allocations often pose problems with respect to reflecting the true cost of each operation, which are incapable of definitive determination. For this reason, a carrier should be, and customarily is, allowed to exercise a measure of discretion in making such reallocations. Under such circumstances, it seems patent that a method, reasonably acceptable to good accounting, once adopted and followed for a period of years, should not be changed retroactively by a carrier where the net effect of that change would be to increase the carrier's need for subsidy support.[33] Yet this is exactly what TWA is here requesting.

We cannot overlook the fact that the Board in the process of establishing a carrier's mail rate (and in periodically reviewing the effects of such rate to determine whether the rate should be reopened) must be free to place reliance upon reported costs as allocated by the carrier in its Form 41 reports. Surely a carrier cannot expect to sit back and at a later date—when it appears to the carrier's advantage—

attempt a retroactive reallocation at the expense of the Federal treasury. Although the Board accords management a fairly wide latitude in originally selecting a cost allocation method and, as appears hereinafter, makes reasonable provision for reallocations that are to be prospective in effect, the Board believes it essential to restrict

33 Compare Knoxville vs. Water Co., 212 U.S. 1 (1909).

severely any attempt by the carrier to reallocate costs retroactively.

On the other hand, we do not intend to preclude a carrier from correcting prospectively what it deems to be errors in its reports, whether such errors flow from deficiencies in its accounting procedures, or from what has been called "reaccounting", that is, judgment changes.[34] We believe that it is reasonable to require that a carrier determine such changes prior to the filing of its final year-end report to the Board. Where attention is directed to accounting adjustments in such report, we would not ordinarily consider it to be unreasonable to reflect such adjustments in the carrier's accounts for the entire year.[35] However, it would be entirely inconsistent with the use made of the carrier's Form 41 reports to offer a broader opportunity for the carriers to change their reported figures. In our judgment, the fact that figures submitted in reports to the Board will be binding upon the carrier is a most important factor in assuring that

12980

quality of management attention and effort necessary to attain reliability therefor.[36] For the foregoing reasons, we reject TWA's request for retroactive adjustment of accounts, without further inquiry into whether TWA has

---

34 Colorado Interstate Gas Co. vs. Federal Power Commission, 142 F. (2d) 943, 957 (C.C.A. 10, 1944) affirmed 324 U.S. 581 (1945).

35 We are cognizant of the fact that TWA alleges that its year-end report for the year 1951 included data for the entire year based upon the revised allocations it here seeks to make retroactive. Aside from the question as to whether TWA had adequately called attention to the revised allocation assumptions involved therein, it is apparent that the report was not filed until after the issuance of the Big Four Mail Rate Case in which the Board relied on TWA's earlier reported data. For reasons hereinafter set forth, we do not therefore accept the revised data for the entire year 1951.

36 Cf. Continental Air Lines, Inc., Mail Rates, Order No. E-5934, dated December 11, 1951, pp. 7-8, finalized by Order No. E-5978, dated December 27, 1951.

actually derived any advantage from its reported understatement of international and overstatement of domestic costs.[37]

The Board's decisions in cases involving Northwest Airlines and Chicago & Southern Cases cited by the carrier are inapposite.[38] In these cases the Board permitted and indeed required transfer of reported expenses from one division to another. However, each of these cases involved a period during which the rates for both international and domestic operations were open. Therefore, to the extent that the domestic division's need was increased by virtue of a shift in expenses from the international division, the Board was able to take the benefit of the international division's reduced need. Moreover, the restatement of expenses for the past period was in our judgment a desirable predicate for the establishment of past and future rates for both domestic and international divisions of the carriers which would more accurately reflect the respective requirements of each

12981

such division for subsidy rates. In the instant case, however, TWA's domestic rate for the period in question is closed. Therefore, except to the extent that the increased domestic profit produced by the reallocations may be

37 But compare Bureau Counsel's contention that TWA's reported expenses prior to the 1952 reallocations were a part of the record upon which the Examiner and the Board relied in renewing TWA's trans-Atlantic route in 1952. (North Atlantic Certificate Renewal Case, Order No. E-6560, dated June 16, 1952.) The carrier, on the other hand, argues that the revised figures were on file with the Board prior to issuance of its decision.

38 Northwest Airlines, Inc., Trans-Pacific Operations, Mail Rates, Order No. E-5838, dated November 2, 1951, finalized by Order No. E-7079, dated January 13, 1953, Northwest Airlines, Inc., Mail Rates (Domestic) Order No. E-5839, dated November 2, 1951, finalized by Order No. E-6338 dated April 18, 1952; Chicago & Southern Air Lines, Inc., Mail Rates (International), Order No. E-5385, dated May 18, 1951, finalized by Order No. E-5793, dated October 18, 1951, Chicago & Southern Air Lines, Inc., Mail Rates, 9 C.A.B. 786 (1948).

available for offset, the reallocations would result in additional subsidy from the Government.

There is an additional and distinct reason for denying any effect in this case for the readjustments sought, at least for the 1947-1950 period. For the period March 14, 1947-December 31, 1950, TWA's domestic rate was established on a past period basis.[39] As we pointed out in our earlier decision in this proceeding,[40] we regard our decision establishing mail rates for 1947-1950 period as having finally disposed of the predicates upon which that rate was based. Under such circumstances, subsequent retroactive reallocations by the carrier changing the cost, revenue and investment data in that proceeding are obviously barred.

In view of the foregoing conclusions, we find it unnecessary to give further consideration to the merits of the reallocations proposed by TWA and opposed on substantive grounds by Bureau Counsel.

One further matter warrants our consideration. Bureau Counsel propose to reallocate (1) reported Korean airlift profits for 1952 in the amount of $232,000 from the domestic to the international division, and (2) reported maintenance expenses for 1952 in the amount of $324,000 from the international to the domestic division.[41] Bureau Counsel contend that the allocation methods

---

39 Since, in determining the net amount of excess earnings available for offset, we will not consider the results of the operations of the domestic division during this period, expenses transferred from the domestic division to the international division will have the effect of increasing the subsidy requirements of the international division. This is not necessarily true for periods for which TWA's domestic rate was set prospectively, since it may be determined that the increased domestic profit produced by the reallocations sought are available for offset.

40 Order No. E-8672, *supra*.

41 Bureau Counsel's position would require similar reallocation in 1953 in the amounts of $94,000 and $329,000 respectively.

used in reporting these expenses and revenues are arbitrary and result in an excessive burden on the international mail rate.[42]

TWA asserts that Bureau Counsel's position with respect to such reallocations is inconsistent with their position on TWA's proposed reallocations in that the sanctity of reported data is as affected by Bureau Counsel's proposed revisions as it is by the carriers. We do not regard Bureau Counsel's position on these matters as inconsistent. Bureau Counsel's proposal to reallocate revenues and expenses which were improperly charged, in such manner as to increase the subsidy claimed, is designed to promote the fair discharge of our regulatory functions and to avoid the payment of unwarranted subsidy. These are the same objectives which underlie our rejection of retroactive reallocations by the carrier.

We turn now to the merits of the reallocations proposed by Bureau Counsel.

Korean Airlift Profits:

Commencing shortly after the outbreak of fighting in Korea, TWA furnished up to six DC-4 aircraft to the Korean airlift. The aircraft originally so utilized were taken from the international division, but subsequent additions and substitutions placed a number of domestic division aircraft in the group. Up until the time that TWA filed its 1951 year-end adjustments in April 1952, it had consistently reported the revenues from this operation as other income of the international division, and had charged most but not all of the expenses thereof to such division. At the year-end closing for 1951, TWA

42 The Examiner, based upon his view of the C&S Case, also found this matter to be moot.

adjusted its reporting for that year to put all Korean airlift revenues and expenses in the domestic division. During 1952 and 1953, the entire operation was reported as domestic.

12982(a)

Neither party supports the "reported" treatment of such profits as proper accounting. TWA contends that the profits should follow the aircraft on one of three bases: (1) the division providing the aircraft, (2) the division that would otherwise have used the aircraft, or (3) the division using the aircraft upon their return. Bureau Counsel submit that each of these three approaches is largely artificial and that the furnishing of aircraft to the airlift was essentially a system undertaking. Bureau Counsel accordingly propose that the Korean profits be split between divisions in the proportion of relative investment of each division.

In an earlier decision dealing with a temporary mail rate for TWA[43] the conclusion was reached that the Korean profits should be applied to offset the need of the carrier's international division. The fact that the aircraft had been taken from the international division and that revenues and expenses relating to their operations had consistently been reported as international were believed to warrant such result. Since that time TWA has demonstrated, through shifting of aircraft and variations of reporting, that any decision resting on such basis would be valueless as a test for the past or guide for the future. The three alternate approaches proposed by TWA appear to be equally susceptible to manipulation and would afford no sounder basis for distribution of such profits. In fact, in the situation here presented, the

---

43 Order No. E-6393, dated May 5, 1952, adopting the findings and conclusions in the Examiner's Report served February 5, 1952.

three proposed approaches are interwoven. An aircraft initially taken from international for the airlift, subsequently returned to TWA and placed in domestic service, then recalled for the airlift, would, on this second assignment be "from" domestic.

12982(b)

With these facts in mind, it is now concluded that the allocation basis proposed by Bureau Counsel, on the basis of relative investment, is the most reasonable distribution of the net profits between divisions. TWA attempts to refute the soundness of this allocation by pointing to the absurd result that would ensue if all of the aircraft of one division were taken for war duty. The other division would then retain essentially all of the carrier's investment and be credited with the profit. But this example is unrealistic and assumes that carrier management would do nothing to reassign the remaining aircraft (investment) between divisions in proportion to traffic demand. It could not be assumed that management would be so inactive or inefficient. In any event, we are not here concerned with a problem affecting a major part of the carrier's fleet.

In accordance with the foregoing, it is concluded that the lease by TWA of aircraft for the Korean airlift is most properly to be considered as a system undertaking and that the net profits derived therefrom in 1952 and 1953 should be allocated between divisions in proportion to relative investment.

TWA has argued that the reported profits from the airlift are subject to future renegotiation under section 106(a)(4) of the Renegotiation Act of 1951, and requests provision in any order for recognition of this contingent reduction of the amounts herein applied to reduce its international division mail pay need. In the first place,

there is no evidence in the record that any of TWA's profits will be subject to recapture as a result of the renegotiation procedure. In addition, it is apparent that in the course of any renegotiation, the carrier would have an opportunity to call to the renegotiation authority's attention the Board's action

and the effect of such action on the overall governmental payments. It cannot be reasonably assumed that the renegotiation authority will in assaying the possible excess profits of TWA disregard the Board's action.

Engine Maintenance Expense:

Bureau Counsel's proposal to reallocate $324,000 of reported engine maintenance expense for 1952 from the international to the domestic division stems from the following facts.

Since 1949, all of TWA's major maintenance and overhaul of Constellation aircraft have been performed at Kansas City. During the period 1949-1952, the carrier has used two engine types in such equipment, the R-3350-BA, which is employed solely on the domestic division's L-49's, and the R-3350-BD, which is employed on the L-749 and L-749A equipment, and which is used interchangeably in the domestic and international divisions. The BA and BD engines are overhauled on the same maintenance lines and by the same personnel.

Prior to 1952, the carrier allocated engine overhaul expense between divisions on the basis of the time and material reports for each engine submitted by its maintenance personnel. The procedure followed was to charge each division for the labor and material costs actually spent for overhauling engines removed from that division's aircraft. In April 1952, TWA submitted reports allocating costs between its domestic and international divisions by

distributing the pooled cost of overhaul of all Constellation engines on the basis of the Constellation hours flown in each division.[44]

12984

Bureau Counsel contend that the effect of the revised allocation procedure is to transfer a substantial portion of its overhaul costs from the domestic to the international division. Bureau Counsel argue that the allocation method employed by TWA after 1952 is arbitrary insofar as it assumes that the overhaul cost for the BA engine, used exclusively in domestic operations, is the same as that of the BD engine, used in both international and domestic divisions. Since TWA after 1952 no longer kept records of material and time records on the overhaul of each engine, Bureau Counsel proposed that TWA's engine maintenance costs for the year 1952 be adjusted on the basis of 1951 experience, resulting in a transfer of $324,000 of maintenance expense from the international division to the domestic division.

TWA agrees that the practice of pooling BA and BD overhaul costs is not justified if the result is to burden BD engines with any part of the true cost of BA engines. However, TWA asserts that its allocation procedure does not have that result. TWA contends that as a practical matter, its method of handling such engines on the same assembly line, and interchanging parts between them has meant that there has been a pooling of such engines at all times. Moreover, TWA contends that when it changed its accounting method it made a special study to determine whether the new method fairly distributed costs and that such study demonstrated that the average over-

44 This is one of the principal reallocation proposals for which TWA seeks approval retroactive to 1949. In the 1949-1951 period this proposal would, if we granted the carrier's request, increase the break-even need of the international division, according to Bureau Counsel, by almost $1,300,000.

haul cost of the engine per hour flown was practically identical. TWA also asserts that even on the revised basis employed, TWA's cost for overhauling the BA engine is lower than PAA's or Air France's for the same engine. TWA also argues that the cost of engine parts for the BA engine is lower than for the BD, that the engine warranty credits are higher, and that the BA design in some aspects permits cheaper overhaul.

12985

Bureau Counsel, on the other hand, contend that TWA's alleged study of comparative overhaul costs for the BA and BD engines is without probative value. It is noted that the study was made *after* TWA had filed reports made on the new basis. They also point out that the evidence clearly indicates that BD engine, which is a later improved version of the BA, is substantially superior to the latter. In addition, our attention has been called to the fact that major parts of the two engines having a substantial bearing on overhaul costs (i.e. cylinders, pistons and values) are *not* interchangeable. Bureau Counsel contend, *inter alia*, that TWA's study was limited to overhaul of the bare engine, and did not include engine components and therefore only tells part of the story with respect to overhaul costs; Bureau Counsel also challenge the size of the sample—the study having been limited to but a total of thirty engines for which the work was performed in a two-week period in the Fall of 1951; and it is also noted that the study was based not upon the actual labor hours spent in performing the various overhaul functions but rather on work standards established by the carrier for the performance of such functions. In addition, it is argued that PAA's experience with BA and BD engines indicates that the former cost about 23 percent more per hour for overhaul than the latter. Bureau Counsel also reject

TWA's contention that it was impractical to keep separate records for the two engine types.

After careful consideration of the contentions of the parties, we have concluded that Bureau Counsel's position on this issue has the greater merit. In view of the extensive history in the record as to the adverse operating history of the BA engine and the satisfactory performance record.

of the BD, and the experience of PAA, as well as that of TWA in the period prior to 1952 when separate cost records were maintained, with respect to greater cost of overhaul of the former, we find it impossible to assume that the overhaul costs of the two engines were identical. Moreover, we are convinced for the reasons cited by Bureau Counsel that TWA's alleged cost study is without substantial probative value. While TWA's method of overhauling both the BA and BD engines on the same assembly line and, to the extent feasible, interchanging parts between them would make it difficult to maintain with absolute accuracy separate cost records for each type of engine, we are convinced that separate records of time and material spent on overhaul could be maintained. Obviously such system would reflect more accurately the true costs of the overhaul of each type than result from the pooling of all such costs. In our judgment the carrier's cost records for 1951, which are based on records separately kept, are a more accurate reflection of actual engine maintenance expense and Bureau Counsel's proposal to use such records as a basis in allocating engine maintenance expenses between the two divisions should be used.

We therefore find that reported maintenance expense for 1952 in the amount of $324,000 and $329,000 in 1953 should be reallocated from the international to the domestic division.

(12987)

12987

Engine Overhaul Reserve

The Examiner, upon a premise which the parties disavow, rejected TWA's request for recognition as an expense of a reserve for engine overhaul. TWA computes expenses attributable to used but not overhauled engine hours as amounting to $532,509 on January 31, 1952. TWA asserts, *inter alia*, that a reserve for engine overhaul is necessary to relate expenses accurately to the period in which the service was rendered, and that the same principles apply to support a reserve for engine overhaul as apply to aircraft overhaul, which even Bureau Counsel is willing to recognize as a proper expense. TWA contends that the Board has in the past not only recognized a reserve for engine overhaul reported by the carrier but has recognized such an expense where no such reserve was reported.

As pointed out by Bureau Counsel, our policy on overhaul reserves has evolved gradually. In the early post war years the Board allowed, and even provided reserves for both aircraft and engine overhaul where none were reported, but we also deducted the value of the first or built-in overhaul from the original cost in order to avoid what in effect would be double charges to operating expenses.[45] Since under a periodic overhaul system aircraft overhauls are usually performed only once every three or four years, accruals to reserves are necessary in order to avoid a distortion in operating results for any given year. However, since engine overhauls are ordinarily performed about twice a year it is not necessary

[45] American Overseas Airlines, Inc., Mail Rates, 9 C.A.B. 695, 699 (1948). Cf. Western Air Lines, Inc., Mail Rates, 10 C.A.B. 285, 290, 291 (1949).

to provide

accruals to reserves to avoid distortion in any one year. With this distinction in mind the Board finally ceased to provide for engine overhaul reserves in those cases where the carrier itself had not placed such reserves on its books.[46] Subsequently, in order to put all carriers on a uniform basis, we adopted the policy of reversing all engine overhaul reserves booked by the carriers.[47] And in this very case, Bureau Counsel has proposed, without opposition, to reverse PAA's recorded reserve for engine overhaul.

In our judgment, engine overhaul expense occurs at sufficiently short intervals to permit the cash expense basis to reflect with sufficient accuracy the true cost of overhaul in a given year. It is not without significance that TWA has actually not found it necessary to establish a reserve accrual in its own accounts although it now seeks recognition of such an accrual as a necessary operating expense. Under such circumstances, it is patent that we could not recognize such an accrual as a proper expense for mail rate purposes.

Flood Loss[48]

The Examiner found that TWA's claim for $620,000,

---

46 E.g., Mid-Continent Airlines, Inc., Mail Rates, Order No. E-6581, dated July 7, 1952, Northwest Airlines, Inc., Mail Rates, Domestic Operations, Order No. E-5839, dated November 2, 1951, p. 29, Appendix 2, p. 3, finalized by Order No. E-6338, dated April 18, 1952.

47 Pan American World Airways, Inc., Latin American Operations, Mail Rates, Order No. E-7441, dated June 5, 1953, p. 29, finalized by Order No. E-7495, dated June 19, 1953. The only exception to this policy has been for certain carriers, principally those engaged in local service operations, who bought war surplus engines where the original cost was less than that of overhaul. In these instances, we have treated the cost of surplus engines as unamortized overhaul cost and have recognized amortization of such costs as part of allowable operating expenses in lieu of depreciation. This technique would result in reducing rather than increasing TWA's breakeven need. In any case, our policy no longer provides a built-in overhaul adjustment for engines.

48 Appendix A, p. 30.

the portion of its uninsured flood loss in 1951 chargeable to its international division, should be recognized as an expense in the year in which the flood occurred.

12989

Bureau Counsel suggests that flood losses, as a predictable casualty loss, should not be recognized as an expense in the year incurred, but rather that the carrier should be credited with a self-insurance reserve, which would have accumulated $151,400 in the 1946-1953 period.

After careful consideration of the contentions of the parties, we have decided to sustain the Examiner's conclusion. The significant factors in our view are the fact that TWA's action in establishing its maintenance base at Kansas City was consistent with statutory standards, and that it was unable as a practical matter to obtain insurance for that portion of its losses here involved. In our judgment, it is not sound public policy to force a carrier to assume the risks of a self-insurer for casualty losses. Yet such would undeniably be the result of adoption of Bureau Counsel's position. The consequences of any such policy could on the one hand result in the bankruptcy of a carrier as a result of a casualty loss due to circumstances completely beyond management's control. On the other hand, the same policy could produce for other carriers windfalls in the form of reserve accruals for risks which never matured. We should be hesitant to adopt any policy having such an uneven effect unless it were clear that it were necessary in order to avoid an undue drain on the public treasury. However, we believe that a consistent application of this policy to all carriers, which has the effect of disallowing as a recognizable expense any self-insurance reserves established by the carrier for uninsurable risks, should in the long run not result in the

Government's being obligated for an additional dollar in mail subsidy.

Termination Indemnity Reserve[49]

The Examiner sustained TWA's claim for $369,586 for a reserve to cover its forecast future termination indemnity liability. The liability here

12990

involved flows from the severance laws of certain foreign countries which establish termination compensation for employees, varying directly with length of service. TWA contends that as its organization matures its contingent liability increases correspondingly and that such liability is sufficiently predictable to give a reasonably accurate basis for the amounts it has accrued. Therefore, it argues that such accruals should be recognized as a valid expense for mail rate purposes. TWA further contends that such accruals are consistent with sound accounting practice.

Bureau Counsel insist that the crux of the matter is not the soundness of such accruals from the standpoint of good accounting but rather whether the accruals are a properly recognizable expense for rate-making purposes. The answer to this, according to Bureau Counsel, turns upon whether the carrier has established a "need" for the expense. In this connection, it is asserted that the sum claimed as a reserve has not been paid out by the carrier, and may never be paid out. Moreover, Bureau Counsel contend that if, in the future, the carrier does incur a liability of the extent forecast, it may then be self-sufficient and have no need for subsidy to meet such liability —or if it still requires subsidy, the Board could in mail

[49] Appendix A, pp. 30-31.

rate proceedings with the actual facts before it determine the extent to which such liability should be underwritten.

We agree with Bureau Counsel's position. The fact that accruals to a termination indemnity reserve are consistent with good accounting practice is not dispositive of the matter before us. Our determination must be based upon principles related to sound rate-making. These in our judgment preclude recognition of accruals to a reserve account for expenses for which a carrier has not demonstrated a current need. For example, we authorize the

12991

establishment by a carrier of a reserve for bad debts but recognize as an expense for mail rate purposes only those bad debts realized in the review period. Thus, in the instant case, we do not condemn the establishment of a reserve for the contingent termination indemnity liability but will recognize as a proper expense only that level of payments actually incurred during the period.[50]

General and Administrative Expenses[51]

Accepting in substantial part Bureau Counsel's proposal, the Examiner disallowed $1,296,000 of the general and administrative expense incurred by TWA in its first three years of operation. Based upon considerations of record, Bureau Counsel's proposal allowed TWA a 20 percent higher level of G & A expense in 1946 than the PAA-AOA average for that year, and the AOA level, which was higher than PAA's, in 1947 and 1948. The total G & A expense recognized is $1,070,000 higher than the average PAA-AOA level.

---

50 Braniff Airways, Inc., Latin American Operations Mail Rates, Order No. E-8354, dated May 19, 1954, p. 8, fn. 6; finalized by Order No. E-8439, dated June 15, 1954.

51 Appendix A, pp. 31-35.

TWA contends, *inter alia,* that its basis for reporting G & A expenses differed from that of other carriers, and that this precludes a proper comparison of costs without a thorough examination account by account. In this connection, TWA argues that Bureau Counsel's position, which was adopted by the Examiner, that TWA would have to support and prove the difference in each account was unfair. TWA contends that the staff had some responsibilities in this matter and should, for example, have called attention to the fact that PAA reports certain accounting employees' salaries as selling expense rather than in G & A where they belong.

12992

We must reject these contentions. In the first place, the record reflects a consideration account by account of asserted differences in reported figures between TWA and PAA. Indeed, Bureau Counsel have proposed and we have here recognized for purposes of comparing TWA's G & A ratio with that of the other carriers such increased expenses as have resulted from accounting differences between these carriers or from misclassifications.[52] The only new contention advanced by TWA before the Board relates to PAA's reporting in the Latin American Division of acounting employees salaries as selling expense. On this score, we think it evident that TWA errs in its implication that Bureau Counsel improperly withheld information as to a substantial difference between TWA and PAA's G & A account. Contrary to TWA's contention, there is no evidence that PAA in the period 1946-1948, reported accounting personnel salaries in the Atlantic Division in selling expense rather than its G & A account.

---

52 In this connection, it is to be noted that Bureau Counsel has partially acquiesced in TWA's assertion that during the 1946-1948 period it misclassified to the G & A account for the international division certain expenses, and have recommended that $1,878,000 of the amount allegedly misclassified be recognized.

TWA's contention is based upon the Board's finding in the recent *PAA Latin American Division, Mail Rate Case,*[53] that $336,000 of "senior representatives and accounting employees' salaries" were improperly reported in the 1948-1951 period as traffic and sales expense rather than G & A expense. However, the Board is aware of the fact that the accounting procedures of PAA's Atlantic Division to some extent differ from those of

its Latin American Division. Moreover, it is apparent that they differ insofar as the reporting of such salary expense. Thus, Bureau Counsel have proposed in this case to disallow substantial amounts of PAA's traffic and sales expense but none of its G & A expense. Nonetheless, PAA has not attempted to reduce Bureau Counsel's proposed disallowance by demonstrating that its Atlantic Division followed the same practice as its Latin American Division of reporting accounting employees' salaries in traffic and sales expense.[54]

TWA—Strike Losses

For the reasons stated in connection with our decision to disallow AOA's losses related to its pilot strike, we find that TWA's losses resulting from the pilot strike in 1946 in the amount of $656,000 should be disallowed.

We also take official notice of the fact that in July 1953, TWA suffered a navigators' strike which resulted in a substantial reduction in the number of schedules provided.

---

53 Order No. E-7441, dated June 5, 1953, finalized by Order No. E-7495, dated June 19, 1953.

54 TWA raises certain other arguments with respect to the fairness of disallowing any of its G&A expense in the first three years of its operations. These arguments have already been considered and disposed of by the Examiner. We find nothing in the arguments addressed to us which warrant any change in the Examiner's conclusion.

We have calculated TWA's loss due to the strike as amounting to $1,387,000[55] which in accordance with our decision on the pilot strike issue we shall also disallow.

12994

Selling Expense[56]

Bureau Counsel have challenged the level of selling expenses for each of the three carriers herein for one or more years of the review period. They proposed generally a maximum cut-off point of 19.5% of transport revenues in the absence of special circumstances. Such special circumstances were found only with respect to TWA in the fact that it was confronted with the superior competitive attractiveness of the B-377 in 1950 and subsequent years. On brief to the Examiner, Bureau Counsel recommended allowance of ½% for TWA for this factor (a 20% ratio). The Examiner agreed with the general level of 19.5% urged by Bureau Counsel and applied it to PAA and AOA. He concluded with respect to TWA, however, that full allowance of its actual selling expenses was warranted as an economic alternate choice to the operation of late model Constellations in more luxurious configurations. On brief to the Board, Bureau Counsel have revised upward their recommended allowance for TWA to approximately 20.5%, on the basis that this will fully compensate TWA for its promotional expenditures (advertising and publicity) to meet the B-377 competition. After consideration of the issues drawn by the parties in the light of the record in the proceeding, we find that except as noted below we are in agreement with the Examiner's conclusions. For reasons adequately stated in the Initial Decision, we

55 The costing of the navigators' strike follows the method adopted by the Board for the pilots' strike. See Appendix 4.

56 Appendix A, pp. 15-21, 36-39, 69-72.

find that the general 19.5 percent level is a reasonable ratio of selling expense to commercial revenue for the past period for AOA and PAA, and that TWA is entitled to an additional allowance, although not in the full amount granted by the Examiner, to meet the greater passenger attractiveness of the Boeing

B-377 as operated by PAA. We shall discuss herein, in addition to the question of the appropriate extra allowance for TWA, principally those matters newly raised by the parties' arguments before the Board.

The Examiner's basic conclusion was that the selling expense ratio is very substantially within the control of management. We agree with that conclusion. It is clearly supported by observation of the substantial change of the ratio during the past period for the carriers herein concerned, for other international carriers, particularly those operating in the Pacific, and for the major domestic carriers.

The essential attack of the carrier parties is aimed at the selection of a 19.5% ratio as the cut-off point. PAA notes that the reported average ratios for all U. S. flag carriers for recent years based upon Bureau Counsel's exhibits, are as follows:

1949	*1950*	*1951*	*1952*
19.8%	20.1%	20.3%	20.4%

With this alleged industry average PAA submits that the 19.5% level cannot be supported. However, we cannot agree wth the asumption that the so-called industry average is a fair standard of selling expenses. Of the nine carriers included in this average, three are divisions of PAA itself, and a fourth (Panagra) is 50 percent owned by PAA and operates as part of the PAA system. Moreover, two of the others, as well as Panagra, operate over

routes with traffic densities approximately half those of the carriers here involved. The remaining three making up the

12996

"average" are AOA and TWA, herein concerned, and Northwest's Pacific operation. In our judgment, greater guidance as to a reasonable selling expense ratio may, as is indicated in the Initial Decision, be found elsewhere in the selling expense ratios of the claimant carriers' themselves prior to 1949, in the experience of the Pacific carriers, and most significantly in the Big Four experience in the period since 1947 when they have moved from subsidy to a service mail rate status.

As noted in the Initial Decision, the highest selling expense ratio of any Big Four carrier in 1952 was 12.5 percent. Thus, we are here allowing the carriers a 7 point additional allowance, since we agree with the Examiner's observations as to the many component items of selling expense that will unavoidably cost more for an international as compared to a domestic operation. In this connection, PAA has called attention to one item—sales commissions to agents—not specifically enumerated by the Examiner. It apparently feels that this omission, plus the Examiner's observation that "Unfortunately no party endeavored to supply a quantitative measure of the difference represented by such items," makes it impossible to rest any conclusion on the domestic carrier's experience. We cannot agree.

While AOA and PAA both took general exception to the Examiner's reliance on an analysis of the domestic Big Four experience, their subsequent briefs and argument specified but the one item of omission relative to commission sales. The Examiner found that a substantial part of selling expense is attributable to employees' sal-

aries. He conservatively concluded that there appeared no reason why this

12997

salary portion of selling expense should be higher for the international carriers than for the Big Four. We have expanded the analysis of the salary costs in the traffic and sales accounts and find that in the 1950-1953 period the portion of commercial revenues expended for such salaries has averaged 2.16% for the transatlantic carriers as against 4.51% for the domestic Big Four.[37] It is noted that these salaries alone constitute 38 percent of the total "selling expense" of the domestic Big Four in this period. PAA submits that sales commissions to agents account for 1 percent of commercial revenue for these domestic carriers as compared to 5 percent for international operators. Acceptance of such figures then indicates that for all items of selling expense other than the direct salaries analyzed and sales commissions, the domestic Big Four spend 6.3 percent of commercial revenue. A 19.5 percent ceiling for international operations will recognize 12.3 percent for comparable selling expense items. Thus the 19.5 percent ceiling allows selling expenditures for international carriers for items other than salaries and commissions at a rate almost 100 percent above the Big Four experience.

Perspective may well be lost in discussing selling expense as a percentage of transport revenue as we do in the foregoing. The annual transport revenues involved are approximately between 30 and 50 million dollars for each carrier. Thus, the additional 7 point greater selling expense ratio which we are recognizing for transatlantic service amounts to 2.1 to 3.5 million dollars a year greater selling expense for each carrier than if we had held these carriers to the experienced ratio of the

37 Appendix 2.

12998

Big Four carriers. Again, it bears noting that we are dealing with a steadily growing traffic so that the imposition of the same 19.5 percent ceiling for successive years still allows substantial increases in dollar expenditures; increases for PAA, for example, of $390,000 in 1950 over the 1949 dollars, of $2,530,000 in 1951 over 1950, and of $761,000 in 1952 over 1951.

We find no special mitigating factors in those advanced by AOA and PAA which would justify upward deviation from this level. AOA's sole argument for special consideration urges an averaging of successive years based on an alleged carry-over effect of selling expenditures. We agree with the Examiner's rejection of this assertion based upon the flexible, short term, management control of such expenditures.

For special consideration PAA contends that it merits a higher allowance than TWA because of its inferior position with respect to density of operations, yield, revenues, and competitive situation. We cannot find that special concession is warranted by the first three factors. It is our opinion that the small unit advantage shown for TWA is fully compensated for by the greater total size of PAA's Atlantic Division operations. As to the fourth item, the competitive situation, we find that the net concession required is in favor of TWA because of the competitive impact of the B-377 as operated by PAA.

In connection with the selling expense issue for PAA, the Initial Decision accepted PAA's request for exclusion of $264,000 representing sales commissions received from Panair do Brasil and

12999

Avianca for sales at European points where those carriers did not maintain their own sales offices. PAA submits

that at such points its commission sales for these carriers should be considered on the basis of a joint facility, which would allocate substantial expense against the commissions earned. The Examiner's acceptance of PAA's contention noted that it was made ". . . in the absence of express objection by any party . . ."[58] In the subsequent procedures Bureau Counsel has voiced objection to the exclusion of these commissions from the selling expense ceiling. Analyzing the sales in issue, Bureau Counsel computes the number of such commissionable sales as approximately 2.5 per day at each of the PAA Stations concerned, and submits that no added station costs can be reasonably attributed to such a small added volume of sales. Considering the direct PAA sales volume at the points concerned,[59] we conclude, as Bureau Counsel contends, that the commission sales made for Panair do Brasil and Avianca are too insignificant a part of the total to warrant the special treatment urged by PAA.

With respect to the allowable level of TWA's selling expense, it cannot be disputed on the facts of record that the B-377, from the start of transport services in 1949, constituted a passenger

13000

attraction of substantial magnitude as compared to other aircraft in competitive transatlantic operation. The gross passenger revenue attracted to PAA's B-377's, measured by the load factor in excess of that realized on TWA's competing Constellation flight, was approximately as follows:

---

58 As the Examiner noted, the PAA evidence relative to these commissions was received in a post-hearing exhibit without objection. On brief to the Examiner, Bureau Counsel made no reference to the merits of PAA's position, but, on the other hand, made no allowance for the related amount claimed.

59 Seven stations have been specifically named: Lisbon, Paris, London, Rome, Frankfurt, Istanbul and Beirut.

(000)

1949	*1950*	*1951*	*1952*
$630	$827	$2,306	$1,373

The Examiner's appraisal of this situation observed that TWA had but two possible avenues of action to meet the superior attractiveness of the B-377, (1) more attractive service, or (2) greater sales promotion effort. He found that TWA's action in electing to meet this problem through greater selling expenditures rather than by employing a more luxurious seating arrangement or larger lounge on its 749A aircraft was a sound action of economic management which resulted in a lower mail pay claim. The Examiner concluded that there should be no disallowance of TWA's reported selling expenses.

Bureau Counsel have consistently proposed that TWA be given special consideration on the allowable level of selling expense because of the competitive impact of the B-377. On brief and argument to the Board they have increased the recommended level for TWA over that urged before the Examiner, from 20.0 percent to approximately 20.5 percent. This upward revision is stated by Bureau Counsel to result from a reappraisal of the dollar expenditures of TWA for

advertising and publicity efforts, all of which Bureau Counsel proposed to allow.

We are generally in accord with the position of Bureau Counsel, and the conclusion of the Examiner, that the superior passenger attractiveness of the B-377 posed for TWA management a major threat of traffic diversion. We agree that a reasonable course for TWA in meeting this situation was to increase its sales effort. But we cannot agree, as is implied in the Examiner's conclusions, that the allowable amount of such added expenditures has a

ceiling related to the higher operating costs of the B-377. While it may be that some of the B-377 features which created its passenger appeal also contributed to its relatively higher operating costs, we can find no direct relationship. The rapid advance of the industry in improved design would give a normal expectation that the L-749A, designed approximately three years after the B-377, would exhibit an appreciable improvement in operating costs. We are accordingly of the opinion that the approach of Bureau Counsel—to determine the reasonable special allowance for promotional effort—is proper in this situation. Bureau Counsel's measurement of this factor would allow ½ of a percentage point above the 19.5% level for traffic and sales expenditures and the actual TWA expenditures in the advertising and publicity accounts. Bureau Counsel's position recognizes that while the advertising and publicity accounts do not reflect all expenses which may be claimed as promotional effort,

13002

they should afford a fair indication of the impact of competitive factors such as are here involved.

While we agree basically with Bureau Counsel's approach, we believe that the application made has certain deficiencies. We note that the change in TWA's Advertising and Publicity expenses has in 1950-1953 averaged 1.8 percentage points above the 1947-1949 level. The 1950-1953 average is 1.2 percentage points above the 1949 level.[60]

---

[60] TWA Advertising and Publicity Expenses as a percent of transport revenue:

1947	1948	1949	1950	1951	1952	1953
3.2	3.7	4.3	5.3	5.5*	5.2	5.9
'47-'49 Ave.		3.7		'50-'53 Ave.		5.5

* TWA's year end reallocation of $253,825 from domestic to international has been excluded.

We recognize that the many factors entering into the special selling expense considerations for TWA rest heavily upon judgment. But it is our conclusion that the special impact of the B-377 is best indicated by the relative increase in TWA's advertising and publicity expense levels before and after that event. Without placing full weight on either the 1947-1949 average, or on the 1949 level alone, we find that a reasonable special allowance for TWA's promotional effort should be 1.5 percentage points above the 19.5% recognized for its competitors, rather than the approximate 1 percent recommended by Bureau Counsel. We accordingly conclude that amounts

expended by TWA for selling expense in excess of 21.0 percent of transport revenues, $372,000 in 1951, $533,000 in 1952, and $879,000 in 1953 must be disallowed for mail rate purposes.

With respect to the future year, we adopt the Examiner's findings and conclusion that the selling expense ratio for both transatlantic carriers should be limited to the 19.5 percent ceiling. Increased expenditures by one carrier in a competitive market start a vicious cycle of increased outlay by all to maintain prior shares of the traffic. Such uneconomic practices would unduly impede the industry's progress toward self-sufficiency. With the anticipated growth of these carriers, the Board expects that these carriers will take vigorous action to further reduce their selling expense ratios in future years.

(13004)

13004

Executive Aircraft[61]

During 1946 and 1947, TWA owned an executive aircraft for which operating expenses exceeded the commercial value of the transportation provided by $51,850. TWA concedes that by Board precedents this sum should not be recognized as a proper operating expense. The aircraft was later sold at a profit, of which $28,778 was assigned to the international division. The question raised is whether this profit should be directly offset against the proposed expense disallowance, or applied as "other revenue" to reduce the breakeven need of the carrier.

The Examiner concluded the investment in executive aircraft should be considered as a single unit—including revenues, operating expenses and profit or loss on the sale of the investment. On this basis, he concluded that the "executive aircraft venture" resulted in a net loss of $23,072 ($51,850 expense disallowance, less $28,778 aircraft sale profit) which should be the amount disallowed for mail rate purposes.

Bureau Counsel contend that pursuant to the requirements of section 406 of the Act, the profit from the sale of the executive aircraft, in excess of a 7 percent return on the investment therein, should be treated as "other revenue" and used to reduce the carrier's breakeven need. They assert that the Examiner's proposal nets against the profits the operating expense of the aircraft, an expense which is unrelated to the generation of the income, and that under his decision, the "more improvident the expenditure, the less profit will be available to the Board to reduce subsidy". Bureau Counsel's proposal would have the effect of reducing the carriers' breakeven need by $80,628.

---

61 Appendix A, pp. 40-41.

We concur in Bureau Counsel's view. In so doing, we take note of the fact that it is necessary in computing the amount of profit to consider those costs which contribute to the generation of the revenue, such as the original cost of acquisition and any capital improvements thereto. However, it is clear that the cost of operating the aircraft has no relation whatsoever to the ultimate sale price obtained. Thus, to deduct such cost from the aircraft sale profit would be merely to reimburse the carrier indirectly for improvident expenditures in maintaining and operating unnecessary aircraft for executive use.

Breakeven need

Based upon the foregoing considerations, TWA's recognized breakeven need for the period February 5, 1946 through December 31, 1953, is $31,459,000.[62]

Investment[63]

The only matter in issue with respect to TWA's investment is whether TWA is entitled to recognition of working capital in excess of 3 months cash operating expense. The general practice of the Board is to recognize for investment purposes the actual working capital of a carrier, provided however, that where such working capital exceeds 3 months cash operating expenses, a maximum of 3 months is recognized.

TWA contends that the Examiner properly recognized that TWA was entitled to special working capital allow-

62 Appendix 3.

63 Appendix A, pp. 42-46.

ances for foreign mail receivables and non-convertible foreign bank balances in addition to the normal three

13006

months requirements.[64] TWA further argues that the Board has in other cases specifically allowed working capital in excess of three months cash expenses where, as in the instant situation, substantial U. S. mail receivables have accrued due to extended deferral of final mail rates.

Bureau Counsel oppose the carrier's request. They agree that TWA should be given special treatment with respect to foreign mail receivables and frozen foreign bank balances, subject, however, to a ceiling of three months cash operating expenses.

We agree with Bureau Counsel's position. The Board has consistently taken the position that working capital equivalent to three months' cash operating expense is sufficient to meet a carrier's need for operating funds.[65] We have departed from this rule only where a temporary rate was so inadequate in relation to the final rate established that the carrier could not have been expected to finance the U. S. mail receivables on the three months' allowance. In such cases, we have recognized an additional amount of working capital sufficient to provide an allowance to cover the cost of financing the mail receivables at short term interest rates.[66] However, we have refused to recognize

---

64 However, the Examiner's decision was not an acceptance in principal of TWA's position, but rather resulted from his reliance upon figures furnished by Bureau Counsel which inadvertently adjusted TWA's working capital allowance, for the factors above referred, in excess of three months' cash operating expenses.

65 E.g., Pan American, Transatlantic Mail Rates, 8 C.A.B. 267, 282-285 (1947); also Colonial Airlines, Inc., Mail Rates, Order No. E-5777, dated October 9, 1951, pp. 57-60 and cases there cited.

66 Pan American, Alaska Division Mail Rates, 8 C.A.B. 244, 252-255 (1947); New York Airways, Mail Rates, Order No. E-8165, dated March 15, 1954, p. 6, finalized by Order No. E-8205, dated March 31, 1954.

more than the normal three months, working capital allowance where the average mail receivable was equivalent

13007

to only one month's cash operating expense.[67] In this case, however, TWA has received more mail pay in the past period than it is being awarded by this decision. It is therefore, clear that on the basis of previous Board precedents, no exception is warranted in this case.[68]

Based upon the foregoing considerations and the facts of record, we find that TWA's return on recognized investment at an annual rate of 7 percent is $15,511,000 for the period February 5, 1946 through December 31, 1953. We also allow Federal income taxes, where appropriate. In recent years the Board has consistently adhered to the actual tax policy. The parties all agree with this policy. Pursuant to this policy, we find the actual tax liability for the review period to be $3,760,000.

Two matters in connection with the allowance for Federal income taxes warrant comment. One matter relates to the provision for 1953 income taxes. Bureau Counsel in their brief to the Board erred in their determination of the income taxes paid by TWA and allocable to the international division. Thus, we are advised that Bureau Counsel inadvertently included in domestic division taxes, certain foreign income taxes which should be included in international mail pay for 1953.[69] The actual

---

67 E.g., Pan American Transatlantic Mail Rate, supra, at pp. 282-285. See also West Coast Airlines, Mail Rates, 10 C.A.B. 104 (1949) Appendix No. 5.

68 Our conclusion is buttressed by our examination of the transcript of the hearing. Thus, TWA's treasurer at several points, in testifying with respect to the need of the international division for working capital, stressed the sufficiency of three months' cash disbursements for their purpose. Moreover, Bureau Counsel's witness explicitly asserted that TWA's foreign bank balances did not justify an allowance greater than three months' expenses.

69 This problem apparently arose from the fact that TWA failed to segregate its foreign tax payment from its domestic income taxes.

amount of these taxes paid was $121,546. On the other hand, Bureau Counsel also properly point out that, consistent with the treatment accorded prior years, the tax credit

13008

available under our laws ($120,852) for the payment of foreign income taxes should be assigned to the international division. In addition, Bureau Counsel has correctly called attention to the fact that TWA's reported system income tax for 1953 was less than that for the domestic division alone, indicating that a tax credit of like amount ($80,803) should be assigned to the international division. In sum, the international division should be assigned a net tax credit in 1953 of $80,109. We deem it proper to use this tax credit to reduce the tax provision in the mail rate for earlier years.[70]

The second matter which requires comment relates to the effect on the allowance for income taxes of any determination on the offset issue which would result in TWA having to refund mail pay already received under temporary rates. Such a determination would result in income tax credits which we would consider in determining the total mail pay sum due TWA.

The carrier's claim for mail pay for its transatlantic operations for this period, apart from any consideration of the amount of excess earnings from its domestic opera-

---

[70] The tax data involved in these computations are set forth below:

	Domestic	International	System
Federal income tax	$4,901,256*	$(80,803)	$4,820,453
State income tax	49,482	—	49,482
Foreign income tax credit	—	(120,852)	(120,852)
Sub-total	$4,950738	$(201,655)	$4,749,083
Provision for foreign income tax in international division	—	121,546	121,546
Total income tax	$4,950,738	$(80,109)	$4,870,629

* Includes deferred tax accrual of $1,428,754.

tions during this same period, totals $50,920,000.[71] Since the carrier has received $51,095,000 in temporary mail pay, there must

13009

be refunded to the Government $365,000[72] without regard to the ultimate determination of the amount of excess earnings of the domestic division, if any, which may be available to reduce the subsidy required for transatlantic operations.[73]

The Rate for PAA for the Period January 1, 1946 to December 31, 1953.

The Examiner found that PAA had a $49,544,000 breakeven need for its Atlantic Division operations in the period January 1, 1946 through December 31, 1952. Bureau Counsel in their brief to the Board recommended that PAA be allowed $52,318,000, plus $4,122,000 more in breakeven need for operations in the year 1953. Bureau Counsel's recommended $2,800,000 increase in breakeven need over the Examiner's findings does not reflect any basic change in position but rather results from certain revisions in calculations as to the disallowances which would result from adoption of such position. PAA, on the other hand, seeks increases in excess of $9,000,000 in the breakeven need recommended by Bureau Counsel, contesting a substantial number of the disallowances proposed by Bureau Counsel and adopted by the Examiner. There is hereinafter set forth our decision on the issues drawn by the parties.

---

71 See Appendix 3.

72 The $365,000 refund consists of $175,000 in mail pay already received by the carrier plus a tax credit of $190,000 which the carrier will get the benefit of in the year in which such amount is refunded to the Government. See Appendix 3.

73 Order No. E-8672, *supra*.

(13009, 13010)

Underutilization of Boeing B-377 aircraft.[74]

The Examiner found that during an initial period of 15 months after inauguration of Boeing B-377 service, from April 1949 through June 1950, PAA failed to achieve a reasonable level of utilization of such equipment.

13010

He, therefore, adopted Bureau Counsel's proposal, which included the suspension of depreciation expense attributable to the underutilized aircraft during this period, and the denial of a return on investment therefor for the same period.[75] Bureau Counsel made a similar proposal with respect to underutilized aircraft for the period immediately subsequent to the acquisition of AOA. The Examiner, however, rejected this proposal on the ground that the conceded underutilization of aircraft in this period was beyond management's control, stemming from delays in obtaining foreign approval for operations into Rome and Paris. The Examiner pointed out that delays of this sort were a risk peculiar to international service for which the Board's past period rate of return made no provision.

It is conceded that the underutilization which is here in issue resulted from the realization of a risk which is peculiar to international operations. In view of our decision with respect to PAA's future rate, in which we have, in effect, refused to support further operations in Boeing aircraft, Bureau Counsel's proposal, if adopted, would not only defer the allowance of depreciation and return on investment in these aircraft for this period, but would effectively deny it. Thus, the carrier would be suffering

74 Appendix A, pp. 46-49.

75 In addition, Bureau Counsel proposed to defer and capitalize hull insurance in the same period, amortizing such amount over the following five year period, and to allow as an expense, interest at the rate of three percent on the amount by which investment was reduced.

a substantial loss as a result of a risk related solely to international operations. As the Examiner points out, our past period rates have been uniformly set for domestic and international operations on the theory that the risks under such rates were identical. We are adhering to such position. Under such circumstances, we deem it proper to recognize

13011

the expenses incurred for the B-377 during the post-merger period when such aircraft were underutilized as a result of delays in obtaining the approval of foreign governments for entry into Paris and Rome.

Engine Maintenance Expense[76]

The Examiner agreed with Bureau Counsel's proposal to disallow over 1,000,000 of PAA's engine maintenance expense in the period 1949-1950.[77] Of this amount $653,000 relates to the R-3350 BA engine used in the Constellation L-49, and the balance to the R-4360 engine used in the Boeing B-377. The disallowance proposed for the L-49 engines was based upon the average of TWA's and AOA's experience during this period, and that for the B-377 engine was based upon AOA's experience.

PAA challenges the Examiner's conclusions with several arguments which are all bottomed upon two basic contentions. First, PAA asserts that since TWA's experience with the L-49 was in domestic operation, it should not be included in the comparison or, if included, TWA's data should be adjusted to reflect higher international costs. Second, PAA argues that neither AOA's nor

---

76 Appendix A, pp. 57-60.

77 The parties by stipulation have set the amount at $1,075,320 which includes $75,000 of indirect maintenance and expense omitted by the Examiner.

TWA's engine maintenance data are sufficiently reliable to permit accurate comparison with PAA.

The Examiner considered and properly rejected PAA's contentions with respect to use of TWA's experience with the L-49 engines. He also adequately disposed of PAA's contention that AOA's maintenance accounts were kept on a different basis than PAA's. We take note of the fact that PAA now seeks

13012

to excuse its failure to produce AOA's records, which are in its possession, in support of its contentions with respect to AOA's different accounting procedures on "the practical necessity for bringing" the extensive hearings to an end. We find such excuse patently unpersuasive in light of the history of the proceeding and the large amount of money involved. PAA also asserts that TWA's engine maintenance experience is not usable because of the difficulty in ascertaining what TWA's costs actually were. In support of this contention, PAA refers to the testimony of Bureau Counsel's witness. However, the transcript does not bear out this argument. As a matter of fact, the witness expressly stated that he was "* * * not aware of any significant difficulties * * *" in making a comparison of total direct engine maintenance expense between TWA and PAA so long as TWA's reported expenses were used.[78]

One further contention of PAA warrants comment. PAA argues that while Bureau Counsel's expert witness admitted that it would be reasonable to compare PAA's

78 T. 5248. The witness further indicated that if any adjustments were made to TWA's figures to reallocate expenses between domestic and international operations, the effect would be to reduce rather than increase engine maintenance expense which would further widen the gap between TWA and PAA's experience.

engine maintenance expense with AOA's, rather than with an average of AOA's and TWA's experience, Bureau Counsel "receded from this position in brief and urged a disallowance based upon a comparison utilizing the average expense of AOA and TWA". We do not find this to be the case. Read in context, it is apparent that Bureau Counsel's witness only conceded that, based upon certain assumptions as to AOA's experience which PAA's counsel suggested, it might be reasonable to test PAA's experience on AOA's results alone. But he expressly stated that it was not unreasonable to use

13013

the average experience of TWA and AOA, and that ordinarily the use of two carriers rather than one provides a better comparative base.

We have, therefore, concluded that the Examiner correctly found that PAA's engine maintenance expense in the year 1949-1950 was excessive and that $1,075,320 of PAA's reported expenses should be disallowed.

Maintenance Ferry Flights[79]

The Examiner adopted Bureau Counsel's position with respect to the disallowance of certain PAA expenses for ferrying aircraft from New York to Miami for the performance of the Number 3 maintenance service in the 1949-1951 period.[80] In reaching this conclusion, the Examiner found that PAA's maintenance practice, which resulted in the ferry flights, was economically unsound, and he also

79 Appendix A, pp. 60-63.

80 The disallowance found by the Examiner was $550,000. Bureau Counsel and PAA have since agreed that PAA should be allowed an increased credit of $39,000 for trucking charges which would have been incurred to haul engines to Miami for overhaul had the ferry flights not been operated. The disallowance has thus been reduced to $511,000.

rejected various contentions of PAA seeking to prove that the amount of the disallowance was excessive.

PAA has not reargued before the Board its contentions with respect to the basic soundness of its maintenance practice insofar as they required the ferry flights, and we find no reason to reverse the Examiner's conclusions on this matter. PAA, however, asserts that the Examiner's analysis of its contentions with respect to appropriate adjustments in the proposed disallowance is inadequate and requests further consideration of these points by the Board.

PAA contends (1) that facilities for the performance of the No. 3 service on the B-377 were not available in New York for at least part of the

period involved and that Bureau Counsel's witness conceded that under such circumstances it may have been reasonable for the carrier to have ferried the aircraft to Miami for this maintenance; and (2) that its facilities at New York were not adequate at any time for the performance of the No. 3 maintenance service in addition to the other work scheduled there, and, therefore, additional hangar space would have been required in New York if the work were not performed in Miami. The carrier asserts that a $109,000 adjustment is warranted on the basis of its first contention, and $100,000 on the basis of its second.

Basic to both these contentions is the assumption that the establishment and continuation of the content of PAA's No. 3 maintenance service was a reasonable exercise of management discretion under the circumstances. However, we cannot accept this assumption. We take note of the fact that PAA does not challenge the Examiner's finding that the greater part of PAA's No. 3 service in this period

consisted of matters which could properly be performed at higher numbered schedules. Such an adjustment of the content of the No. 3 service could have led to substantial reductions in the personnel, time, and facilities necessary for the performance of the service. Such evidence as there is in the record with respect to alleged inadequacies of facilities at La Guardia or Idlewild, including the testimony of Bureau Counsel's witness referred to by PAA, is premised upon the No. 3 service as performed by the carrier. Without considering the weight this evidence would be entitled to, if we made that assumption, it is apparent that it would not support the conclusion that with a reduced content for the No. 3

13015

service, facilities at La Guardia during the 1949-1950 period were inadequate,[81] or that PAA would have required additional space at Idlewild after 1950 in order to perform the No. 3 service there.

We have considered the other matters raised by PAA's exceptions in support of which it relied on its brief to the Examiner. We find nothing therein which warrants a change in the Examiner's conclusions or further discussion on our part.

All Cargo Service[82]

The Examiner concluded that the Board should underwrite all of TWA's all-cargo service, and should recognize

---

81 PAA also contended in the hearing that weight limitations prevented any B-377 maintenance at LaGuardia, during the period in question. However, the record elsewhere effectively refutes this contention, showing that in the early period of operation, B-377 maintenance was actually performed by PAA at LaGuardia.

82 Appendix A, 23-30, 67-69. We are here discussing matters before us with respect to the all-cargo service of both TWA and PAA.

all but $245,000 of the cost associated with PAA's service. Underlying the Examiner's conclusion were findings (1) that based upon Board policy prior to April 1, 1949, the carriers were entitled to support of a single weekly round trip cargo service until May 1, 1949, and (2) that subsequent to such date, all-cargo services should be recognized only to the extent that they earned revenues adequate to meet the added costs of the service and a return on the investment devoted thereto.

TWA and PAA support the Examiner's decision. Bureau Counsel accept the Examiner's ultimate conclusion with respect to TWA, but would increase PAA's disallowance to $300,000. Seaboard and Western asserts, *inter alia*, that the Examiner erred in calculating the expenses of all-cargo service on an "added" cost basis, that a proper costing of the all-cargo service (i.e., on

a fully allocated basis) would result in a disallowance for TWA and a greater disallowance for PAA.

Bureau Counsel contend that the Examiner erred in crediting all-cargo flights with the entire revenue from the foreign mail which they carried. Bureau Counsel assert that such credit should be calculated on the basis of determining the revenue which would be lost if such service had not been operated—which they do on the assumption that, if the all-cargo flights were eliminated, the carrier would retain the great bulk of such traffic on its other services. However, we find Bureau Counsel's position here inconsistent with that taken elsewhere in this proceeding; namely, that the movement of foreign mail is responsive to proper scheduling and management effort.[83] If the latter position is correct, and we believe it is, it has not

[83] See pp. 80-83, *infra*.

been shown that with the elimination of the all-cargo service the carrier would have retained the traffic forecast by Bureau Counsel.

Insofar as Seaboard's principal contention is concerned, we believe that the initial decision sets forth adequately the reasons why it is appropriate to cost the all-cargo service of the certificated carriers on an added rather than fully allocated basis, as well as the basis for the direct cost allocations made. Seaboard challenges the Examiner's use of PAA's average cargo yield figures to compute revenues from all-cargo service, contending that the cargo handled in all-cargo aircraft, because of its larger size, moves at lower average rates than the smaller packages customarily handled in combination equipment. However, as Seaboard points out,

13017

the record does not permit any separate identification of the relative composition of cargo traffic carried on combination equipment and that carried on all-cargo flights, nor is there any clear inference possible that the revenue yield from cargo carried on all-cargo equipment was substantially less than that carried on combination equipment. Under such circumstances, we cannot accept the revenue yield adjustment sought. We, therefore, must sustain the Examiner's finding that the disallowance of the costs of all-cargo service should be limited to PAA in the amount of $245,000.

(13017, 13018)

Non-Divisional and other Non-Operating Income[84]

The major area of disagreement under this issue relates to the proper treatment of income derived from PAA's investment in other companies. As a result of our decision to treat the year 1953 as part of the past period, we have further reviewed the non-divisional income reported by PAA. Included in such category in the period 1946 through 1953 was a total of $5,729,000 in dividends and interest received by PAA from investments in other companies.[85] In addition PAA made capital gains on sales of securities of $614,000 which were also reported as non-divisional income. Approximately half of this revenue came from companies from which the total income received by PAA over this period, including dividends, interest and capital gains, exceeded seven percent, after taxes, of PAA's cash investment. The total amount of such income in excess of seven

13018

percent after taxes was $1,394,000.[86]

Bureau Counsel contend that to the extent that income received from any of these investments exceeds related operating expenses, capital costs, and taxes, the excess should be considered as "other revenue" and used to reduce PAA's subsidy need. PAA opposes such treatment

84 The "non-divisional" category is one established by PAA in its reports to the Board and covers various investments and undertakings which are of a general corporate nature as distinct from the four operational divisions. Investments in other companies, Government Securities, and revenues and expenses related to Government contracts are typical of "non-divisional" items, though the category includes many others.

85 The principal addition to the amounts included in Bureau Counsel's exhibits to the Examiner was a $775,000 in dividend income received from Panagra. See Appendix 8.

86 This is exclusive of dividends and interest received from investments included in working capital. There is no dispute about the inclusion of such income as other revenue.

on the grounds, *inter alia*, (1) that it would be contrary to the Board's 1947 decision setting rates for PAA's transatlantic division,[87] (2) that the Bureau's approach considers only the profitable investments without offsetting others, (3) that a 7 percent return is unrealistic for investments of the risk character here involved and (4) that it is improper to base profit calculations on PAA's original investment and ignore the plowed back earnings which have increased the investment base.

The Examiner, basing his conclusion on PAA's second ground that all PAA's investments should be viewed as a unit, found that the total of PAA's income on its aggregate recorded investment in other companies did not exceed 7 percent, after taxes, and therefore, that there was no "other revenue" available to reduce its breakeven need. Bureau Counsel excepted to this conclusion, and while PAA supported the conclusion, it specifically asked the Board to reaffirm its earlier decision that investment income such as that here involved does not come within the ambit of section 406 of the Act.

As we pointed out in the 1947 case upon which Pan American relies, "the meaning of 'all other revenue of the air carrier' which the Board is required

to consider in fixing fair and reasonable mail rates under section 406(b) is one of the most difficult phrase in the entire Act to interpret."[88] The course of history since this expression of view supports this statement. Thus, for example, the multitude of issues raised in connection with the question of offset of excess earnings of other divisions stems, in considerable part, from the construction placed

87 Pan American Airways, Inc., Transatlantic Mail Rates, 8 C.A.B. 207.

88 Ibid.

upon this phrase. It is, therefore, understandable that the Board's views on the particular matter here involved, namely, the treatment of income derived from investments outside of the direct air transportation enterprise for which the carrier was certificated, have been reconsidered over a period of years, and that decisions have been made at various times which appear to be inconsistent not only as to the result reached but also in the approach used.

We deem it appropriate at this time to restate our views with respect to the reach of the "all other revenue" language as applied to income received from non-certificated activities. The Board in the 1947 rate case, upon which PAA relies, took the position that the "other revenue" language only embraced revenues from "air carrier activities", i.e., from activities which would warrant subsidy support if losses had resulted rather than profits.[89] On this basis, we excluded from consideration fees earned on military contracts, and profits realized on the sale of stock in a subsidiary corporation.[90] In recent years, however, the Board has taken the position that so long as the revenue producing activity in question stems from or is connected with the carrier's aviation activities, the income

13020

therefrom should be considered as other revenue and used to reduce the carrier's breakeven need, even though such activity is not so closely related to the transportation function as to warrant subsidy support if it proves unprofitable. Based upon this policy, we have specifically reversed our decision in the 1945 *Transatlantic Case* with respect to military contract fees. We have also recently taken into consideration as other revenue income from

89 Id.

90 Pan American, Trans Pacific Mail Rates, Order No. E-5882, dated November 21, 1951, p. 21 of the mimeographed copy.

fixed base operations[91] and manufacturing activities[92] which in the 1945 *Transatlantic Case* we indicated were beyond the scope of the "other revenue" provision.[93]

The principal point of departure from our earlier views was the *Western Case*.[94] We there restated our policy with respect to the scope of the "other revenue" provision in language which clearly foreshadowed our decision here. Thus we said that:

> "The real test, then, in the application of the 'other revenue' clause of the Act lies in the extent to which a showing can be made that any revenue producing activity of the air carrier is a separate and distinct operation apart from the air transportation services performed. * * * If in future mail rate cases circumstances disclose that revenues are derived from unrelated activities of an air carrier, their exclusion may be warranted, but the mandate of the Act for underwriting the operations of need carriers includes the corollary consideration that all revenues generated by the air carrier be used first to reduce the contributions of the Government, unless compelling reasons dictate otherwise. The rights that are granted under a certificate of public convenience and necessity carry with them the obligation of management to exercise its initiative in developing the maximum attainable revenues from the operation of its air transportation services and activities incidental thereto."[95]

---

91 Piedmont Aviation, Ins., Mail Rates, Order No. E-7089, dated Jan. 19, 1953, p. 7, finalized by Order No. E-7123, dated January 30, 1953.

92 All American Airways, Inc., Mail Rates, Order No. E-7088, dated Jan. 19, 1953, pp. 7-8, finalized by Order No. E-7122, dated January 30, 1953.

93 See Pan American, Transatlantic Mail Rates, *supra*. p. 290.

94 Order No. E-4870, dated Nov. 24, 1950, Order No. E-5467, dated June 20, 1951, affirmed in part Western Air Lines v. C.A.B., 347 U.S. 67 (1954).

95 Order No. E-4870, *supra*, p. 14.

Because information with respect to the relationship of other activities to a carrier's transportation function is peculiarly within the knowledge of the carrier, the Board in the *Western Case* and subsequent proceedings has placed the burden of proof of separateness—if exclusion from the "other revenue" provision is sought—upon the carrier.

It is clear that PAA has not sustained that burden. The investments here involved are principally in foreign subsidiaries with whom Pan American has considerable connection in its aviation activities. Thus, Bureau Counsel point out that the more lucrative of those companies[96] feed traffic to PAA and in turn benefit substantially from traffic generated by PAA's certificated operations. In addition, close agency relationships are maintained between Pan American and those companies for the performance of various aviation services. It is apparent, as Bureau Counsel point out, that PAA's investments in these companies would not have been made in the first instance had PAA not been an international airline. Similarly, Bureau Counsel point out, without contradiction by the carrier, that PAA's investments in Airgraphs, Ltd., and Hotelera Venezolanas would not have been made apart from PAA's activities as a certificated air carrier.

With these facts in mind, we think that it is obvious that PAA has not borne the burden of proving that the income with which we are concerned was derived from activities which are separate and apart from its air carrier activities. We, therefore, find that income from these companies must be considered as "other revenue".

---

96 Bureau Counsel was referring, *inter alia*, to Cia Mexicana, Aerovias Venezolanas, and Middle East Air Lines. However, his statements are equally applicable to Panagra.

In concluding that income from PAA's investments from its affiliated companies must be considered to be other revenue, we of course deem it appropriate to consider any expenses related to the earning of the income, or taxes attributable thereto, as a proper charge against such revenues. In addition, where we take into consideration revenue from a given company to reduce the carrier's subsidy requirement, we deem it fair and reasonable to include PAA's recorded investment in such company in the carrier's recognized investment base, since such investments, though unrelated to the performance of certificated services, have become used and useful in the realization of revenues considered in the determination of the subsidy.[97] Under such circumstances, the carrier would receive a 7 percent return on its recorded investments in these companies for the past period. It is apparent that unless we excluded from the investment base the recorded investment in companies from which PAA realized a return of less than 7 percent, we would in effect be subsidizing these investments. Obviously, the Congress had no intention that the Board should underwrite with subsidy losses from non-air transportation activities. Consequently, we shall include in PAA's investment base only PAA's investment in those companies in which PAA has realized income, after related expenses and taxes, in excess of the overall rate of return on investment recognized in the established mail rate for the period. By the same token, since we have excluded from the investment base the investment in those companies which

---

97 Compare Western Air Lines, Inc., et al., Mail Rates, 14 C.A.B. 201, 243, 677 (1951), reversed on other grounds 347 U.S. 67 (1954), where the Board included restaurant and certain other profits of the carrier as other revenue to reduce the carrier's required subsidy without eliminating the investment in such activities from the carrier's investment base.

have not been used and useful in meeting the carrier's subsidy needs, it is only equitable that we also eliminate the income realized from such investments.

We turn now to the contentions of the parties. First, we shall discuss Pan American's opposition to the use of its recorded investment in each of its affiliated companies as its investment base. Pan American asserts that the investment should be calculated on the basis of the underlying value of Pan American's investment in each affiliate as distinguished from the recorded investment on its own books. The difference between the two investment calculations is represented primarily by the reinvested earnings of affiliates which have had the effect of increasing Pan American's underlying equity in various companies although the recorded investments remain unchanged. However, PAA's proposal is contrary to our firmly established policy of using the actual cost to the carrier as the investment base.[98] The shareholders of a subsidized company are obviously not entitled to a return on anything more than the original purchase price of income producing property, whether such property be aircraft or securities.

Moreover, we propose to use the actual cost to the carrier as the investment base, since, insofar as the present record shows, it is impractical for the Board to attempt to reach retained earnings of these companies. In the first place, the books and corporate records are in many instances outside our jurisdiction. Moreover, it is by no means clear that PAA has actual control over the earnings of the companies in which it has invested. Outside of the question of whether PAA's interest in such companies is sufficient to

---

98 American Airlines, Inc. Mail Rates, 3 C.A.B. 323 (1942); Pan American Airways, Transatlantic Mail Rates, 1 C.A.B. 385 (1939).

give it control over dividend policy, for example, there is the constant question, upon which this record sheds little light, of whether the foreign exchange controls of the various countries in which PAA affiliates are domiciled would permit the payment and transfer abroad of the full earnings of such affiliates. Under such circumstances it would indeed appear to be inequitable to reduce PAA's required subsidy by the as yet unrealized earnings of its foreign affiliates. Moreover, since we exclude the undistributed earnings in the calculation of PAA's other revenue, we believe it clear that such undistributed earnings should likewise be excluded from the investment base or from the calculation of capital cost.

Pan American also suggests that a rate allowance calculated at 7 percent of Pan American's recorded investment is inadequate for investments of the risk character here involved. However, the total amount of Pan American's investments in affiliated companies which we have included in its investment base does not exceed but a few percent of the total recognized investment for the certificated operations of the four divisions of the Pan American system. Where these investments are such a minor part of the total recognized investment we believe it is apparent that the 7 percent return which the Board has consistently allowed carriers as a fair rate of return for past periods of operation is a reasonable rate of return.

PAA makes one further point which, if accepted as it was by the Examiner, would result in a conclusion that PAA had no "other revenue" from affiliated companies to be offset against its subsidy requirements. Thus the Examiner considered as a unit the over-all results of PAA's investments in all of its associated companies. The Examiner concluded that a "reasonable policy must accord management the latitude of any multi-investment

enterprise in answering to its stockholders, that of balancing the good against the bad." On this basis, he netted those investments from which PAA realized less than a 7 percent return in

13025

the review period against those where a greater return was received and concluded that PAA fell short of realizing a 7 percent return on its non-air carrier investments.

We have considerable difficulty in basing our interpretation of the requirements of the "other revenue" provision on the shareholder's expectations. It is apparent that the Examiner had similar difficulties for he found it necessary, in order not to frustrate the evident purpose of the "other revenue" clause, to distinguish between those investments "* * * which make use of the carrier's status as an air carrier * * *", and those which do not; the former he would separately consider, and the latter he would treat as a single unit netting earnings deficiencies against earnings over 7 percent. We see no statutory basis for the distinction suggested by the Examiner.[99] Logically the Examiner's test would apply to all revenue from non-certificated activities and would require that all earnings deficiencies from any such activities be netted against income from more profitable investments before any "other revenue" could be offset against the carrier's requirements. Thus for example, losses in fixed base operations or restaurants would have to be offset against profits from investments or sale of equipment.[100] Obviously such a policy

---

99 In this connection, it is to be noted that the Examiner somewhat inconsistently would eliminate the test of relationship to the air carrier enterprise as a basis for including income in the "other revenue" provision.

100 But compare the following cases: Pan American World Airways, Inc., Transpacific Services, Final Mail Rates, Docket No. 2147, Order No. E-5882, November 21, 1951, the Board included airlift revenues, without offsetting disallowed cargo service expenses, contributions and other non-operating expenses (See Appendix No. 3). See also, Hawaiian Airlines,

could have the effect of extinguishing the "other revenue" provision of the statute.

In our judgment, the proper policy is to regard each investment as a separate undertaking.[101] There is no evidence that these investments are

13026

necessarily related, one to the other, or that PAA was required to invest in all of them in order to derive returns in excess of seven percent from some of them. Moreover, it is obvious that PAA could, if it chose, dispose of one or more of its investments without reducing the value of its remaining investments.

It is our view that the only consideration in determining the allowability of a proposed offset to other revenue is whether or not the proposed cost was incurred in obtaining the revenue. For example, the only proper offsets to the gross revenues received from nonscheduled operation are the expenses associated with such operations. Likewise, in the case of PAA's investment income, we are allowing a return on the assets associated with the production of such income which is equivalent to the capital cost recommended by Bureau Counsel. PAA's proposal on the other hand would, in effect, result in the carrier receiving an allowance for capital costs incurred in the holding of entirely separate investments which have not produced any of the revenue included in other revenue. This view is inconsistent with the evident purpose of the "all other revenue" provision of section 406 (b) which requires the Board to consider the results from non-

Ltd., Mail Rates, Docket No. 4162, Order No. E-6197, March 11, 1952 (losses on retirement of nonoperating property not offset against "other revenue") ; Colonial Airlines, Inc., Mail Rates, Docket No. 2724, Order No. E-5777, October 9, 1951 (nonoperating expenses not offset against gains from retirement of nonoperating property).

101 See the cases cited in the foregoing footnote.

certificated activities only to the extent that such activities produce revenues for the carriers.[102]

One further matter requires our consideration. Bureau Counsel originally took the position that the Board should offset all of PAA's non-divisional income against the need of the Atlantic Division. However, Bureau Counsel in their brief to the Examiner accepted PAA's view that the Board should only take into account such portion of the non-divisional income as would be allocable to the Atlantic Division on the basis of relative investment. By stipulation with

PAA, it was also recommended that there be taken into account the allocable share of the Latin American Division for the period April 5, 1948 to December 31, 1952.[103]

In our judgment, Bureau Counsel's original position was the sounder one. PAA has recorded this income on a non-divisional basis, and none of the non-divisional income or expense was considered in the rate cases involving the operations of the carrier's other divisions for the period beginning in 1946. It may be noted that in the case of income derived from Compania de Aviacion, Pan American, S. A., Bureau Counsel have properly pointed out that the carrier may not now seek to allocate all income from this source to the Latin American Division since "• • • the carrier, by consistently reporting such income as non-divisional is foreclosed from claiming otherwise under the policy against retroactive reallocations."[104] We see no reason why, at this late date, any of the non-divisional

---

102 Robinson Airlines Mail Rates, Order No. E-6623, dated July 22, 1952.

103 This stipulation was reached by the parties in order to permit the finalization of the LAD mail rate.

104 Bureau Counsel's position with respect to this item would appear to be inconsistent with the basic position on non-divisional income which they urge be allocated among PAA's various divisions.

income should be reallocated among PAA's operating divisions, especially where the effect of such reallocation may well result in portions of this income not being available to reduce PAA's breakeven need.[105]

Based upon the foregoing conclusions, we find that PAA had a total of $3,872,000 in non-divisional income in the 1946-1953 period which should be offset against the breakeven need of the Atlantic Division. However, it should be noted that PAA will be allowed $759,000 as a return on investment in those companies producing the income which we have included in these

13028

calculations. Thus, PAA's mail compensation has been reduced by a net amount of $3,113,000.[106]

We have not here made any forecast of the investment income which PAA may receive from its affiliates in the future period since the parties did not present any such issue to us. However, in our judgment a sufficient history of income from such investments may now have been accumulated as will permit a reasonable forecast to be made. However, PAA's rate for the Pacific Division is open for the period on and after January 1, 1954.[107] An appropriate opportunity will be either there presented or available in the reopened hearing on the offset issue to consider further whether such a forecast should be made to reduce the mail pay required for PAA's operations.

---

105 See pages 13-21, *supra*. Thus, for example, the portion of this income allocable to PAA's Pacific Division, for the period in which it was on a final rate, may be beyond our reach if we adopt this view.

106 There is included in this figure $1,719,000 of income from sources other than investments which it is agreed is properly included in other revenue. See Appendix 8.

107 Docket No. 6429, instituted by Order No. E-7981, dated December 21, 1953.

13029

PAA—*Excess Need.*[108]

A substantial part of the evidentiary record and of the parties' briefs and arguments to the Board has been directed to the question of whether PAA can and should be required to justify its apparent mail pay need in excess of that of TWA over comparable segments, and whether PAA has made a showing adequate to sustain this burden. The Examiner denied PAA's contention that the Board lacked the power to proceed in such fashion, found that PAA was, in effect, properly directed to "show cause" in justification of the apparent excess need, and, on the merits, held that PAA had failed to justify a substantial part of the indicated excess need under the standards of section 406 of the Act. PAA has excepted to each of these rulings and urged their revision on brief and argument to the Board.

PAA submits that the mail rate to be provided under section 406(b) must consider ". . . the need of each such air carrier . . .", not the need of some other air carrier. The carrier notes that extensive use has been made of the comparison technique with respect to *specific* items of cost but submits that acceptance of such approach affords no support for the *general* disallowance here proposed. PAA cites a number of decisions of courts and administrative agencies in support of the proposition that differences in cost between companies do not establish inefficiency or form the basis for a disallowance. We do not

13030

perceive that our decision herein departs from that principle. For example, it has been recognized that a major

[108] Appendix A, pp. 77-85.

part of the PAA excess need has stemmed from the operation of the carrier's B-377 aircraft which have had higher unit costs than the aircraft operated by its competitor, TWA. We are, however, recognizing those higher costs since it has not been shown that the selection and operation of the B-377 during the review period was inconsistent with the statutory standards of honest, economical and efficient management.

The essence of PAA's contention is, that before disallowing any part of a carrier's reported need we must find and specify the related management action which was dishonest, uneconomic or inefficient, and, that such finding must rest upon something more than the fact that another carrier had a lesser overall need. We reject this contention in the light of our broad statutory authority under section 406 of the Act to establish uniform class rates. For example, in the *Big Four Case* we noted that the Board, in judging the performance of carriers for mail rate determinations, must resort to comparisons among carriers and employ statistical methods. We further expressed our conclusion that the comparative method was sound so long as reasonable precautions were taken to allow for differences in essential characteristics of the carriers compared. We recognize the data available to the Board and to parties other than the reporting carrier is not the sum total of all information which may have a bearing on any given issue. Hence, when comparisons based upon such reported data indicate an unexplained excess

need for any carrier, that carrier is given full opportunity to advance other evidence which it may possess having a bearing on the issue. PAA submits that it has now made

proper explanation of its claimed excess mail pay need and its contentions will be weighed and determined.

Substantially divergent positions have been taken by the parties as to what part of PAA's total Atlantic Division operations should be considered as comparable to TWA's operations for orientation of the amount of excess need to be justified. TWA urged that all of PAA's Atlantic Division services except those beyond Lisbon to South Africa be so considered. Bureau Counsel contended that it was proper to exclude PAA's Bermuda services, its U. S.-Scandinavian services, and its U. S.-South African services. PAA urged the exclusion proposed by Bureau Counsel plus its London-Vienna operation. The Examiner's decision fell in between the positions of PAA and Bureau Counsel, finding that the portion of the London-Vienna service beyond Frankfurt should be excluded, resulting in a reduction of the excess need area by one million dollars. Even assuming the validity of the Examiner's observation that PAA's Frankfurt-Vienna operation has no parallel on TWA's route, we find that Bureau Counsel's definition of the comparable area does not result in unfair treatment for PAA. Thus, as Bureau Counsel point out, in defining the comparable area, Bureau Counsel excluded the entire U. S.-Scandinavian operations, including the U. S.-London portion, and the entire U. S.-South African operation, including the U. S.-Lisbon portion; both the U. S.-London and U.S.-Lisbon portion of these operations could properly be included in the comparable area. And in our judgment, Bureau Counsel's exclusion of these operations from the comparable area clearly offsets the inclusion therein of the Frankfurt-Vienna operation of PAA. We accordingly conclude that the area of PAA's

13032

excess need is reasonably defined in the figures advanced by Bureau Counsel, summarized by years as follows:[109]

000

1948	*1949*	*1950*	*1951*	*1952*	*Total*
$74	$3,418	$3,101	$4,889	$3,652	$15,134

PAA has advanced in exceptions, brief, and oral argument, several additional claims in reduction of that excess need which are opposed by Bureau Counsel and were rejected in the Initial Decision. Thus, PAA asserts that TWA had a major advantage for both cost economies and higher revenues because of the integration of its transatlantic and domestic routes. Specifically, PAA asserted that TWA's ability to route its international aircraft in domestic revenue service to the main overhaul base at Kansas City permitted savings of $525,000 in the 1949-1952 period. In the first instance, it should be noted that Bureau Counsel in allowing PAA the higher cost of maintaining and operating the B-377 and L-049 aircraft have already recognized in substantial part such higher maintenance expenses as PAA may have incurred. In addition, the Examiner observed that PAA had somewhat similar opportunities via charter of maintenance flights between New York and Miami, and that TWA's breakeven need figures for comparative purposes included

13033

amortization of various capitalized expenses which PAA did not incur which gave PAA a cushion of approximately one million dollars. We concur in these observations. We would also note that at the far end of TWA's international route in India it must charge its full terminal costs

---

109 We are recognizing the substantially revised figures relative to this issue agreed to by PAA and Bureau Counsel subsequent to issuance of the Initial Decision, submitted as PAA Stipulation 2, as properly reflecting the position of Bureau Counsel.

to its international route, whereas PAA can and does split its costs at Calcutta between its Atlantic Division, here involved, and its Pacific Division, for which mail rates have been separately set. No party has specifically evaluated this latter factor and we find it unnecessary to do so. The opposed considerations clearly outweigh PAA's claim.

PAA's claim of a traffic disadvantage because of the end-on connection of TWA's domestic and international routes at New York was rather broadly opposed on the ground that PAA's long established name and round-the-world routes gave it compensating advantages, and further that TWA's domestic competitors sold international travelers from domestic points via PAA rather than TWA. TWA's contentions in this regard are sound. Confirmation of this view may be found through reference to the Airline Traffic Surveys. A spot check on U. S.-Paris traffic in September, 1952, indicates that TWA had some advantage from its domestic points, that this was completely offset when all other points in the top 50 domestic traffic stations were included, and that when through traffic to and from Caribbean, Central and South American and Pacific points was added PAA achieved a substantial

13034

advantage.[110] For all of the reasons stated above, we

[110] September, 1952 transatlantic passengers between Paris and:

	TWA	PAA
1. TWA domestic points (except New York and Boston)	331	285
2. Other domestic points (top 50)	51	98
	382	383
3. Other points (Caribbean, etc.	85	245
PAA advantage		151

It also bears noting that U.S.-Paris flights scheduled in September, 1952 were 21 weekly for TWA; 11 for PAA. Origination-destination passengers between New York or Boston and Paris totaled 1,487 for TWA and 2,032 for PAA in that month.

conclude that the TWA advantages accruing from its domestic system are more than offset by PAA's other advantages.

PAA has also argued for reduction of the excess need area on the ground that TWA's proposed retroactive reallocations as between domestic and international are still inadequate.[111] It points to a proposed TWA reallocation for 1950 of legal fees ($15,516) and broadly contends that the formula applied in earlier years was equally faulty and therefore that additional provision should be made for 1949 and 1948.[112] We cannot agree that there should be further narrowing of the excess need area by virtue of such additional constructive reallocations. As compared to PAA's very broad approach we note that TWA's

13035

proposed reallocations cover every year from 1946 through 1951. Items as small as $351.00 in 1947, below $1,000 in three of the six years, and below $1,500 in all but the last year, have been singled out by TWA and proposed for reallocation. The entire TWA approach to the reallocation issue indicates a rather close screening of past allocation bases, and certainly there existed adequate incentive for the carrier to present all claims which it considered reasonable. We cannot, therefore, give weight to PAA's contention that TWA must have overlooked additional items of this magnitude.

We find merit in PAA's contention that the area of apparent excess need should be reduced to reflect a lower cargo yield over its African route subsequent to 1949.

111 We have rejected TWA's proposed reallocations for purposes of determining its mail rate. However, in determining the area of PAA's excess need, we have allowed for those reallocations which would have been meritorious for TWA had such reallocations not been rejected for other reasons set forth on pages 13-21 *supra*.

112 The contention also refers to a $51 reallocation of G. & A. expense ($74,841), urging at least a 50% revision for 1950, 1949 and 1948.

Because of the sterling devaluation in the fall of that year, PAA has shown that its subsequent cargo yields have there averaged about 20% less than the divisional average. Refusal of Bureau Counsel and the Examiner to recognize this fact has the effect of putting into the area of excess need for the comparable segments an amount which properly represents a claimed need of PAA's Africa route. PAA's contention that it endeavored without success to obtain conference approval of cargo rate increases for the African service subsequent to the devaluation is not controverted. In these circumstances, we conclude that the resultant mail pay need for the African service is compensable under the standards of the Act.

The nature of the excess need issue, according to PAA, appears in a substantially different light at the time of submission to the

13036

Board for decision than it did at the time of the Examiner's initial decision. PAA notes that at the earlier procedural stages PAA appeared to have a need in excess of that TWA for each year subsequent to 1947. As a result of the conferences between PAA and Bureau Counsel subsequent to issuance of the Initial Decision, and the agreements embodied in the PAA stipulation 2, PAA submits that it now appears to have significant excess need in only two years out of the former five. After making allowances for variances explained by PAA, it computes its excess need over TWA as follows on the basis of Bureau Counsel's position:

	1946	*1947*	*1948*	*1949*	*1950*	*1951*	*1952*
Excess Need–334	–2,226	74	2,516	–993	1,423	–197

(000)

Total of all years 263
Total of years with unexplained need 4,013

PAA submits that the broad concept of excess need cannot be limited to certain "hand picked" years, 1949 and 1951, but that the evaluation must net the excess for the entire period. On the overall approach PAA would justify the relatively small apparent excess of $263,000 and thus dispose of the entire issue.

We cannot accept PAA's argument. The nature of the issue has not changed by virtue of the revised dollar amounts reflected in PAA stipulation 2. The fact still remains that on the basis of mail pay need per revenue ton-mile for the comparable operations PAA claims and will receive a greater amount than TWA for each year of the review period other than 1946 and 1947. We agree with the Examiner's conclusion

13037

that these two post-war years of inaugural activity are severable from the later years, that there has been no demonstration of any interrelation between PAA's lower unit need in the two early years and its higher need in 1948 and later years.

Our objection to netting the years subsequent to 1947 can be readily seen by considering the year 1952. The amount of PAA excess need for that year requiring justification is approximately 3.6 million dollars. PAA has shown that the higher cost of its B-377 operations in that year accounts for about 3.8[113] million dollars. Hence, once we agree to underwrite the higher PAA aircraft costs in this year, PAA claims that it now becomes more efficient than TWA to the extent of 200 thousand dollars for 1952. It asks that it be credited for such amount in some other year where it otherwise fails to explain the apparent excess need. We reject such approach. Obviously our acceptance

[113] A small part of this amount relates to the higher cost of PAA's Constellation aircraft.

of the B-377 for the period through December 31, 1953 does not require the conclusion that PAA's operations in 1952 were more efficient than TWA's. Support for Boeing operations is not predicated upon a finding that this was the most efficient decision which could have been made, but rather upon the determination that the decision was within the area of reasonable management latitude which is compensable through mail pay under the standards of the Act. But no basis can be found for transforming such a finding of acceptable management action into one of greater efficiency than TWA's which would be necessary to permit the year

to year offset sought by PAA. We will accordingly review PAA's contentions in justification of the indicated excess need for each of the years 1948 through 1952.

By far the major item advanced by PAA in explanation of its excess need is the higher operating cost of its B-377 and L-049 aircraft as compared to TWA's L-749 and 749As. The parties have agreed that this item alone is adequate explanation of the apparent excess need for the years 1950 and 1952.[114] It explains substantial portions of the excess need for 1949—$902,000, and for 1951—$3,466,000. We agree with the Examiner's conclusion with respect to underwriting these high costs during the review period and accordingly accept this item as partial explanation of the apparent excess need.

The next most significant item advanced by PAA in justification of the remaining excess need relates to foreign mail revenues. The Examiner found that the foreign mail revenues received by PAA over the comparable segment for the review period were approximately

---

114 It also provides an adequate explanation of PAA's excess need in 1953 on the basis of reported figures.

6.8 million dollars below those of TWA. PAA contends for recognition of this amount in full as constituting a factor completely beyond the control of management. Bureau Counsel join TWA in opposing this position on the basis that the development of foreign mail traffic is to some extent within the control of management in the same manner as is other commercial traffic, responsive to adequacy of schedules and promotional effort. Bureau Counsel would however distinguish, and make allowance of $1,172,000 for, a disparity of access to foreign mail in Spain and

13039

India where the principal dispatch of such mail was from points served by TWA but not by PAA. The Examiner accepted the difference in access to foreign mail in Spain and India as proper explanation of some apparent excess need, and further found that the two carriers' route structures call for an additional concession to PAA involving mail volume differences from Switzerland and Greece (TWA) as compared to Belgium (PAA). We are in agreement with the Examiner as to the amounts accepted in explanation of PAA's excess need relative to foreign mail.[115]

PAA has directed appreciable argument against the Examiner's conclusion that, except for the adjustments recognized, PAA and TWA had relatively equal opportunity to obtain foreign mail traffic. Those arguments, however, relate essentially to the years 1948, 1950, and 1952, years for which the accepted explanations relative to the B-377 and foreign mail have satisfied the excess need issue. For 1949 and 1951 we affirm the Examiner's conclusion. To the extent that PAA may have failed to attract an equivalent amount of foreign mail traffic in these two years it

115 See Appendix A, pp. 83-86.

appears reasonably related to carrier effort or the inherent scheduling frequency disadvantage that attaches to the use of an aircraft of larger capacity. For these factors management must be held accountable. The adoption of the Examiner's position with respect to PAA's foreign mail credit wipes out the apparent excess need for 1948, and reduces it by $489,000 for 1949 and by $451,000 for 1951.

PAA further submits that all prior attention devoted to the foreign mail allowance has focused on mail moving to the United States. In its

13040

brief to the Board, PAA for the first time submits a further analysis relating to foreign mail moving between foreign points and claims that TWA realized a volume advantage in this area equaling 17% of the volumes moving between foreign points and the U. S. It accordingly requests that all allowances otherwise accepted be increased by that amount. We reject this claim on the ground that it is not substantiated in the record. PAA itself conceded that the record contained no detailed information as to this type of mail movement.

Finally, with respect to foreign mail allowance, PAA argues that the Examiner erred in deducting from the foreign mail revenue allowance an amount representing the revenue from other commercial traffic which he held would thereby be constructively displaced. We agree with the conclusion that there must be an offset for such constructively displaced traffic. A subsidiary contention of PAA challenging the Examiner's use of PAA's average yield from all other commercial traffic, rather than its lesser cargo yield, presents a closer question. PAA argues that its B-377's had a relatively large cargo and mail capacity and that to the extent that it had to forego other

traffic to accomodate the constructive foreign mail loads here concerned it would have displaced low priority cargo rather than passengers. PAA further notes that in the all-cargo issue the Examiner recognized this contention in computing a constructive displacement of cargo traffic to accommodate the U. S. mail shifted from disallowed all-cargo flights. While we have not disturbed the generally agreed computations relative to the all-cargo issue, we are of the opinion that the Examiner's result is reasonable as to the present issue. Foreign

13041

mail carries a top priority and obviously cumulates on flights to the U. S., reaching its maximum on the transatlantic hop. This segment has consistently run at high load factors, substantially above the system averages of around 60 percent. Having made one constructive displacement of cargo over this segment in the earlier issue we have no clear showing as to how much, if any, remains for further constructive displacement, or, alternatively, if such further constructive displacement of cargo were made, whether it would detract so from PAA's cargo service that a drop in volume should also be constructed. Such considerations, on balance, lead us in our judgment to affirmation of the Examiner's conclusion.

With the foregoing decisions in mind, we have concluded that PAA has failed to justify its claimed excess need in the amounts of $2,863,000 for 1949 and $651,000 for 1951. The Examiner's analysis of this issue led him to place responsibility for PAA's higher need on the traffic policies of its management. While other explanations can be offered, it is apparent that these policies account for at least a substantial portion of PAA's excess need. As the Examiner pointed out, PAA may properly be charged for having obtained a lower yield per revenue ton mile

than TWA for operations in comparable areas. In its brief to the Examiner, PAA claimed that in 1951 the differential in yields and composition of traffic amounted to $3,374,000. It is, therefore, apparent that this figure alone is more than enough to account for the total excess need disallowance in that year. In 1949, this figure is claimed to be

13042

$1,784,000 and represents a substantial part of the total disallowed. The balance of the amount disallowed in 1949 may in large part be attributed to the excess capacity operated in that year for which Bureau Counsel proposed a disallowance of $659,000.

Other contentions argued by PAA on this issue have been considered and found unpersuasive. On the basis of the foregoing, we find that disallowances in the amount of $2,863,000 for 1949 and $651,000 for 1951 should be sustained.[116]

One further item relating to the "excess need" issue remains for disposition. As with the 1949 excess capacity issue, the Examiner also merged into the excess need area an issue separately raised by Bureau Counsel relative to PAA excess capacity in 1952 between the U. S. and Paris. In the present posture of the excess need issue for 1952—eliminated on the basis of a 3.8 million dollar allowance for the B-377's higher operating costs—we find it appropriate to treat this excess capacity issue separately. We agree with the Examiner's conclusion that, as a separate issue, the practice which is here involved—reduced seating to maintain an uneconomic frequency of operations—calls for our strong disapproval. Management's election to use the B-377 to serve this market must accept the schedule frequency limitations that go with the use of an aircraft

116 See Appendix 7.

larger than its competitors. We find that PAA's refusal to follow this principle gives rise to a claim of $88,000 in 1952, which amount must be disallowed.

13043

Breakeven Need

Based upon the foregoing considerations and all of the facts of record, we find that PAA's recognized breakeven need for Atlantic Division operations between January 1, 1946, and December 31, 1953, is $58,986,000.[116a]

Return on Investment

The return on recognized investment at a rate of seven percent per annum for the past period is $23,525,000.[116a]

Taxes

As previously noted in connection with TWA's past period rate, we will make an allowance for Federal income taxes based upon the actual tax liability of the carrier. Based upon the aforementioned determination as to the recognized breakeven need and return on recognized investment, we find that PAA should be allowed $7,958,000 as provision for Federal income taxes.[116a] It is to be noted that this determination is made without regard to the possible outcome of the offset proceedings we have heretofore ordered.[117] Obviously, if the outcome of such proceedings results in a determination that excess earnings from other divisions are available for offset purposes, it will also affect the carrier's tax liability. We will,

116a Appendix 6.

117 E-8872, *supra*.

therefore, make appropriate adjustments, if required, in the offset decision in order to avoid the payment to the carrier of sums for tax allowance in excess of that actually required to meet its tax liability.

The mail pay claim of the carrier for the period 1946-1953, without regard to the possible offset of excess earnings of PAA's other divisions totals $90,469,000, which is an increase of $6,810,000 over amounts received by PAA under temporary rate orders.[117a]

13044

Rate of Return[118]

The Examiner found that the carriers should be afforded a 9.3 percent return on recognized investment for the future period, rather than the 10 percent rate heretofore awarded for international operations, and should be granted the established 7 percent return for the past period. All the parties have taken exception to the future period rate, and the carriers have also excepted to the 7 percent past period rate.

There is little dispute here as to legal requirements with respect to the rate of return. As the Supreme Court has stated in the *Hope Natural Gas Case*,[119] the rate established "* * * must enable the company to operate successfully, to maintain its financial integrity, to attract capital and to compensate its investors for the risks assumed * * *".[120] However, there is considerable question as to whether these tests as applied to the current position of the air carriers would require a higher or would warrant a lower rate of return.

117a Appendix 6.

118 Appendix A, pp. 87-99.

119 320 U.S. 591. (1944).

120 Ibid. at page 605.

The carriers argue that historically airline securities are held in poor repute, that in recent strong security markets they have "* * * lagged conspicuously behind the procession * * *", and that these facts point strongly to the need for an increase in the previously established rates of return if the air carriers are to be enabled to attract the capital they need for further growth.

Bureau Counsel, on the other hand, emphasize the operating rather than the financial history of the carriers, pointing to the remarkable

13045

record of achievement of the trunkline industry generally and PAA and TWA in particular under reported rates of return on investment considerably lower than 9 percent.

In support of their position that an increased rate of return should be granted, the carriers each submitted analyses of the cost of capital which, while varying as to details, would support an overall rate of return of 13 percent. Bureau Counsel and the Post Office Department, following the same basic technique as the carriers, arrive at rates between 8 and 9 percent.[122]

After careful evaluation of the record and the contentions of the parties, we find that a fair and reasonable return on investment for PAA and TWA's transatlantic operations in the future period is 9 percent, and 7 percent in the past period. In reaching our decision we have been guided, in part, by what we believe to be a fair application of the cost of capital approach. We have also relied, in part, upon our judgment (based upon the carriers' experience in the past and our prognosis of the future development of these carriers) as to an overall rate of return which will enable each carrier, under honest, economical and efficient management, to maintain and develop

122 See Appendix A, pp. 89-98 for description of the techniques followed.

the air transportation enterprise for which it holds a certificate of public convenience and necessity.

In reaching our conclusion that a 9 percent return is reasonable for the future, we have taken note of the fact that the domestic trunkline industry reported earnings of 8.6 percent on investment from 1939 to 1953,

13046

and under these earnings the carriers have flourished. Since 1939, there has been tremendous growth in the airline industry in terms of capacity and traffic. It has shown a steady improvement in safety, speed, equipment reliability and in general service to the public. Despite inflation, the increasing efficiency of the industry has enabled it to provide transportation at relatively low charges to the public, and as a result, patronage of air transportation services has constantly grown.

Except for short periods where carriers have been involved in strikes, or where there has been a serious question as to general operating efficiency, there is no evidence as to any inability on the part of the trunkline industry generally, or of PAA and TWA in particular, to obtain necessary financing for replacement or expansion needs. In fact, PAA has historically been a leader in the development and introduction of new equipment and the same is true of TWA.

In determining the reasonableness of a 9 percent rate of return to meet the carriers' needs, there is one additional factor which we must consider. That is the Board's depreciation policies. We have in the past deliberately followed a very conservative policy with respect to the periods over which carriers are permitted to depreciate equipment. This policy was designed to provide the maximum protection against loss on disposition of equipment consistent with the overall public interest. As a result of

such policy, there have been relatively few occasions when equipment has had to be sold at a loss. As a matter of fact, today both TWA and PAA operate fully depreciated Constellation equipment which will be useful for many years. The relatively short period of time over which the Board has allowed

the industry to recoup the cost of its equipment through depreciation charges has been a tremendous aid in the financing of new equipment, which is by far the greatest capital need of the industry. It has enabled the carriers to borrow at low interest rates. It has contributed to the financial strength of the carriers' balance sheets. Thus, our depreciation policies not only directly affect the carriers' need for long term capital but also have a substantial impact on the cost of such capital as they do need.

Nothing that we have here said about the reasonableness of a 9 percent return for prospective international rates starting on January 1, 1954 is inconsistent with the reasonableness of the 10 percent prospective rate heretofore provided for international operations. Thus, it is apparent that at the outset of international operations, the uncertainties and inherent risks greatly exceeded those of today. This is due not only to the great advances in technology which have made transoceanic operations a routine and relatively hazard-free operation, but also to the operating efficiency and economic knowhow which comes in substantial part from experience. Put in other terms, it should be apparent that to the investor there is less risk attached to an enterprise which has operated successfully for several years than in one which is about to or has only recently started its operations.

We turn now to a consideration of the "cost of capital" approach to these airline enterprises. In doing so, we

must stress the fact that this has been only one of the elements that has guided us in our conclusion as to what should be the proper rate of return. As will be manifest

hereinafter, the techniques of constructing the "cost of capital" are complex and necessarily involve large elements of judgment. Therefore, the results obtained are at best a guide to the proper rate of return rather than an automatic solution to the problems posed.

The Examiner, in our opinion, satisfactorily resolved the basic issues with respect to a proper approach to determination of the cost of capital for these airlines. Thus, he separately determined the cost of debt and the cost of equity capital. The cost of debt was figured at the average interest rate paid by the Big Four carriers or 3.5 percent, which is also a representative rate for the transatlantic operations. In determining the rate of return required for equity capital, the Examiner based his conclusion on the historic relation of common stock earnings to market price for the Big Four airlines for the period 1949 through 1952, the latest year for which statistics were then available. This he found to be 11.2 percent. To this figure he added 1.0 percent as compensation for the greater risk of international operations, and 0.1 percent as an allowance for flotation costs. The Examiner allowed nothing for underpricing or market pressure. The rate of return on equity so calculated was 12.3 percent.

Finally, the Examiner applied the equity and debt rates thus determined to a capital structure intended to be an average of the Big Four structure as of December 31, 1952, the last day of the period for which data were then available. The overall rate so constructed was 9.3 percent.

Each of the parties excepted to the Examiner's conclu-

sion. For the most part the exceptions are directed toward judgment matters which we, after careful consideration of the record herein, find to have been resolved

13049

reasonably by the Examiner. However, there are certain calculations made by the Examiner which require correction, and others which should be adjusted to take account of more recent data.

Thus, we would include in the calculations for determining the cost of equity capital the earnings-price ratios for the Big Four carriers through June 30, 1954. Not only is the use of this data consistent with the Examiner's view that the investor is influenced primarily by the most recent market history, but the addition of another year and one-half to the historical period reviewed goes far to meet Bureau Counsel's contention that the period used by the Examiner was too short to avoid distortion due to unusual short term influence (e.g., the Korean War). The earnings-price ratio thus determined is 11.47 percent.[123]

The parties apparently agree that the Examiner understated the increment to the equity rate which should be allowed for underpricing and flotation costs. There is no dispute with respect to the practice of underwriters requiring that the offering price of a new security be at least five percent under its current selling price. As for

---

123

	Big-Four Earnings-Price Ratio
Average 1949-1952	11.20
1953	13.65
12 months to 6/30/54	10.60
Arithmetic average for the six year period 1949 through the 12 months ended 6/30/54	11.47

flotation costs, the carriers assert they should be allowed the industry average of 9.73 percent. Bureau Counsel, however, contend that TWA and PAA as large carriers would float larger issues generally with a lower rate of flotation cost than the industry average and that a 7 or 8 percent allowance is sufficient.

13050

We believe that this contention has merit and that an 8 percent allowance for flotation costs would be a reasonable one. Bureau Counsel make one further point which was adopted by the Examiner and which we believe merits our support. Thus, it is pointed out that flotation costs and market pressure allowances should not be applied to all the equity component of the capital structure but only to that portion which is raised by security flotation since there are no added costs associated with equity obtained from plowed back earnings. Bureau Counsel would thus reduce the total flotation cost and underpricing allowance by 40 percent.[124] Based upon these conclusions, there should be added to the equity rate a 7.8 percent allowance for flotation costs and underpricing. With the adjustments thus indicated, the indicated return on common stock is 13.36 percent.

We turn now to a consideration of the appropriate

---

[124]

Flotation costs	8.0 percent	
Underpricing	5.0	
	13.0 percent	
Reduced by 40 percent to account for portion of equity capital contributed by plowed back earnings		
Earnings price ratio	7.8 percent of 11.47=	.89
Allowance for international risk		11.47
		1.00
Total		13.36

capital structure upon which to base the overall rate. Bureau Counsel have contended for the use of each carrier's own capital structure, which would result in what is called a differentiated rate of return. However, we agree with the Examiner's view that airline capital structures have not as yet reached the degree of stability of other public utilities and that a differentiated rate of return is not warranted at this time.

On the other hand, Bureau Counsel point to certain problems in the use of the Examiner's approach to an average or normal capital structure upon which to base the overall rate of return. Thus, Bureau Counsel properly

13051

call attention to the fact that the Examiner inadvertently omitted from the average Big Four structure which he used, certain large blocks of preferred stock which United and American have outstanding. Bureau Counsel have urged the inclusion of such stock in the average Big Four structure if the overall rate were to be based upon the Examiner's view. We agree with Bureau Counsel's position. However, assuming that the rate of return of the preferred stock component should be derived on the same basis as that of the common stock, we find that the rate should be 5.6 percent rather than 6.5 percent as suggested by Bureau Counsel.[125]

In addition, Bureau Counsel argue that since the earnings-price ratio, upon which the equity return is based,

---

125 Average yield of the AA-UAL preferred stock in the period 1949-June 30, 1954, was 4.73%

Flotation costs at 7.8%	.37%
International risk at amount conceded by Bureau Counsel	.50%
Total rate of return	5.60%

is affected by the debt-equity ratio, instead of the average Big Four capital structure as of the last day of the period considered used by the Examiner, it would be more appropriate to use the average debt-equity ratio over the entire period. While the debt-equity ratio is undoubtedly a factor which investors consider in determining the value to be placed upon an equity offering—it is only one of many such factors, and there is no evidence in the record that the airline common stock earnings-price ratios vary directly with changes in the equity-debt ratio. We therefore believe in cases such as this, where there has been a considerable reduction in the debt component over the review period and no evidence that in the future the debt component will reach earlier proportions, that it would be inappropriate to reflect fully the average equity-debt

13052

ratio over the entire period in the normal capital structure. On the other hand, we believe that it would be equally inappropriate to completely disregard the influence of the debt-equity ratio upon the common stock earnings-price ratio. Based upon Bureau Counsel's view using the average equity-debt ratio over the entire period the overall rate of return would be 8.449 percent.[126] Based upon the Examiner's view using the average Big Four

126

Rate of Return
Based on Big Four Average Capitalization
Year 1949-1st six months 1954

Capital Component	Average % of Total Capitalization	Rate on Component	Rate
Debt	38%	3.5%	1.330
Preferred Stock	15%	5.6%	0.840
Common Stock	47%	13.36%	6.279
			8.449

capital structure as of June 30, 1954, the last day of the period for which we here used earnings-price ratios, the overall rate of return would be 9.118.[127] We believe that a 9.0 percent rate of return properly balances the conflicting considerations in use of appropriate equity-debt ratios to which we have referred.

The foregoing findings as to an appropriate application of the cost of capital approach for determination of the allowance in the mail rate for return on investment supports the Board's conclusion that a 9 percent rate is fair and reasonable for these carriers. While the 9 percent overall

rate is considerably lower than the overall rate of 13 percent sought by the carriers, it makes adequate provision, in our judgment, for the cost of capital. The rate provides a return on common stock of over 13 percent which should be sufficient, in view of the limited risks assumed by the carriers, to permit them to secure any necessary equity financing. Nor do we believe that a 9 percent overall rate of return is unduly high. As detailed more fully in the Initial Decision, the industry's financial history insofar as security offerings are concerned has been less than satisfactory, and it is apparent that an improvement in this record over a period of time will be necessary before

---

127

Based on Big Four Average
Capitalization at June 30, 1954

Capital Component	Average % of Total Capitalization	Rate on Component	Rate
Debt	32%	3.5	1.120
Preferred Stock	14%	5.6	.784
Common Stock	54%	13.36	7.214
			9.118

a lower rate of return—closer to that allowed other public utilities—will be adequate to meet this industry's financing needs. It is not without significance that both the Post Office and Bureau Counsel, while advocating the adoption of public utility techniques to the determination of cost of capital, indicated a belief in the reasonableness of an overall rate varying between 8 and 9 percent as compared with public utility rates commonly in the vicinity of 6 percent.

It is our considered judgment upon all the facts of record that a 9 percent rate of return for PAA and TWA's transatlantic operations under a future period rate is a fair and reasonable rate. Moreover, in the light of the broad considerations which we have taken into account in establishing the 9 percent rate, we will apply the 9 percent rate to our other international flag operations, unless a substantial change in facts is shown. It should also be noted that we have, in establishing the 9 percent rate, given consideration to the 8 percent future rate which we have applied for domestic carriers. Nothing in our decision herein is intended to derogate from this established rate. Insofar as the past period rate of return is concerned, we agree with the reasons advanced by the Examiner as substantiating the reasonableness of continuing this rate at 7 percent.

13054

Future Period Mail Rates for TWA and PAA

Future Rate Period[128]

The Examiner concluded that the future rate for Pan American and Trans World should start on January 1, 1953. The principal reasons stated for this conclusion were (1) that the use of the Initial Decision procedure had materially delayed disposition of the case for reasons

[128] Appendix A, p. 98.

beyond control of the parties, and (2) that the evidence in the record is inadequate, without further hearing, to permit the year 1953 to be treated as part of the past period, or to permit the forecasts for the year 1953 submitted by the parties to be used as a basis for a future rate starting January 1, 1954.

The carriers support the Examiner's conclusions contending (1) that they have been "on notice" that the future period would start on January 1, 1953, and have had all the "incentive to economy and efficiency" which a future rate is intended to engender; and (2) that the Board has in the past established future rates at dates long prior to the date of the Board's final order.

Bureau Counsel and the Post Office Department have taken exception to the Examiner's conclusion. It is contended that the delay resulting from the initial decision process is no different from time necessarily spent in other procedural stages and warrants no special treatment.[129] Bureau Counsel point out that the carriers have had the protection of section 406 of the Act during the pendency of the proceeding, and are not

13055

entitled to the additional benefit of a future rate of return. In this connection it may be noted that based upon our conclusion as to an appropriate future rate of return on investment (see pages 86-95 *infra*) the carriers would receive almost two million dollars more in return on investment alone if we were to treat the year 1953 as a future year, rather than as part of the past period. Bureau Counsel also contend that the Board may, without further hearing, treat 1953 as part of the past period and start the future period on January 1, 1954. In addition,

---

129 Compare National Airlines, Inc., Mail Rates, Order No. E-8128, dated February 19, 1954.

it is asserted upon authority of the *West Ohio Gas Case*[130] that the Board is without power to fix rates upon the basis of forecast results, as it would do for the year 1953 under the Examiner's ruling, when actual results are available.

While we have some doubt as to the force of the *West Ohio Gas Case* when applied to facts such as those here involved, we find it unnecessary to resolve the question as to our power to treat 1953 as a "future" year, since it is our considered judgment that the public interest requires that the future rate period should start no earlier than January 1, 1954. Parenthetically, it is to be noted that if we were to adopt the Examiner's view, both as to the mail rate and date for the start of the future period,[131] the Government would be obligated for mail pay for TWA and PAA for the year 1953 of about 24 million dollars, whereas if 1953 is properly treated as part of the past period, the carriers will receive a total of less than 15 million dollars in mail pay. It is apparent that the carriers were

13056

under the umbrella of section 406 during the entire year 1953 and were subject to none of the business risks[132] which would warrant the award of the higher rate of return allowed when operations are being conducted under a final prospective rate.[133] It is to be noted that the Board has in other cases taken cognizance of changed circumstances, resulting in increased need, ocurring subsequent to the date proposed for inauguration of the future rate period.[134] Nor do we believe that the carriers

---

130 West Ohio Gas v. Commission, 294 U.S. 79 (1935).

131 But see pages 101-115, *infra*.

132 See Braniff Final Mail Rate Case, Order No. E-7815, dated October 13, 1953, pp. 13-14.

133 Pan American Airways, Inc., Mail Rates, Latin American and Miami-Leopoldville, 8 C.A.B. 876, 901 (1947).

134 E.g., Pioneer Air Lines, Inc., Mail Rates, Order No. E-7473, dated June 12, 1953.

have earned a right to substantial additional subsidy merely because the choice of the Initial Decision procedure[135] deferred issuance of the Board's decision. We have on other occasions indicated that we will not establish a so-called "future" rate on a forecast basis, when the actual data for the period is available even though this necessitates moving forward the date originally contemplated for the start of the future period.[136]

The carriers assert that in other cases we have set the date for starting a future rate period at a considerable period prior to the date of the final rate order. Our attention has, however, been called to only one case where the time lag would even approach that here contended for. This is the *Pan American, Latin American Division, Mail Rate Case*,[137] where the Board

13057

decision issued July 24, 1947, made final a mail rate starting on September 1, 1945. However, as we have previously noted in our discussion of the offset issue in the opinion issued September 29, 1854,[138] the *LAD Rate Case* while in form a "future" rate was akin to a past period rate in that it was based in substantial part upon actual rather than forecast data. Moreover, the rate established was a service rather than subsidy rate; thus, the carrier was

135 See Rule 27 of the Board's Rules of Practice which provides in a mail rate case for certification of the record to the Board for decision unless a party requests that the Examiner issue an initial decision. TWA in this case requested the use of the Initial Decision procedure. The record does not indicate any objection by any other party to such request.

136 Colonial Airlines, Inc., Domestic System, Mail Rates, Order No. E-5777, dated October 9, 1951; Robinson Airlines Company, Mail Rates, Order No. E-5957, dated December 9, 1951.

137 8 C.A.B. 876.

138 Order No. E-8072.

awarded no higher rate of return on investment through arbitrary selection of an earlier than warranted initial rate date.

We of course recognize that, as a result of the time necessary for the final setting of rates attributable to the ordinary decisional process, we have on limited occasions because of unusual circumstances established the start of a prospective rate period at a date a year or more prior to that of our final order. We do not believe this indicates any departure from our basic policy of not establishing a future rate on forecast data when the actual results of operations are available. As a matter of fact, it is apparent that our disposition of this proceeding is almost a year after the January 1, 1954 date we believe warranted to start the future period herein.

The carriers have also disputed Bureau Counsel's contention that we may proceed to a decision with respect to a future year commencing January 1, 1954, without further hearing, using such argument to support their view that the future period should begin one year earlier. Despite our concurrence in the carriers' desire to dispose finally of this proceeding, we do not deem this objection to be of sufficient weight to require

13058

the fixing of the future rate period as of January 1, 1953, in view of the additional mail pay this would necessarily involve. On the other hand, we deem it advisable to take such measures as we can to expedite the conclusion of the proceeding, since we recognize the advantage to the Government, as well as the carriers, of having the carriers on final prospective rates. We are therefore proceeding to a decision on a final future rate without further delay, applying the rate principles established on the basis of

data for the years prior to December 31, 1952, to the most recent data reported by the carriers.[139]

13059

The Rate for TWA for the Period Beginning January 1, 1954

The Examiner, following Bureau Counsel's forecast based upon 1952 operating data, found that TWA's break-even need for a future year would be $2,772,000 and that the carrier should receive $8,507,000 in total mail pay (including return on investment at 9.3 percent and allowance for Federal income taxes). The Examiner noted the reasonableness of future rate forecasts by comparing them with reported results for the year ended September 30, 1953. Bureau Counsel supported the Examiner's conclusion by pointing to reported results for the year ended March 31, 1954, as indicating the reasonableness of reliance on the forecast future rate. TWA, on the other hand, asserted that still later reported figures—those for the year ended April 30, 1954—showed that required mail pay greatly exceeded the Examiner's result.

Our scrutiny of TWA's operating results for the year 1953 reveals a serious deficiency in the use of the reported figures for that year to test the adequacy of Bureau Counsel's forecast. As previously indicated herein, TWA suffered a navigators' strike in July 1953 which drastically curtailed its operations and caused a loss to the carrier in excess of one million dollars.[140] Thus, the

139 Of course, if the carriers raise factual matters which require determination upon an expanded record, we recognize that further proceedings may be required. In such case, if such proceedings were to result in any further delay in the determination of final future rates it is patent that we would be required to reconsider the appropriate cut-off date for the past period.

140 See page 35, *supra*.

use of reported data for a year such as 1953, which includes the strike month of July, results in an overstatement of TWA's required mail pay of more than one million dollars.

In any case, when the forecasts of the parties are tested, in accordance with our customary procedure, by the most recent reported data, it is evident that, were we to base TWA's future rate on 1952

13060

data alone, it would result in a substantial overpayment to the carrier. Thus, it is to be noted that TWA's reported figures for the year ended September 30, 1954, without any adjustment, indicate a reduction in total mail pay required by the carrier of over 2 million dollars in the future mail pay that would be awarded on the basis of 1952 data alone.[141] When reported figures for the year ended September 30, 1954, are adjusted, in accordance with the applicable rate principles applied to past period results,[142] TWA is indicated to have an adjusted operating profit, before mail pay of $259,000. Moreover, as adjusted, TWA's most recent reported figures show an annual reduction in required mail pay to $4,281,000.[143]

It is apparent from the foregoing discussion that TWA's mail pay need has been progressively reduced since 1952. Its need, when proper adjustment is made to eliminate the loss due to the effect of the strike in July 1953, was less in 1953 than in 1952, and was less in 1954 than in 1953.

---

141 Appendix 10.

142 E.g., disallowances for (a) selling expenses over 19.5 percent of commercial revenues, (b) executive salaries over $65,000, (c) entertainment, contributions, etc., expense and (d) accruals for a termination indemnity reserve. See appendix 10.

143 Appendix 10.

With these facts in mind, we would be remiss in our responsibility were we to base TWA's future rate upon forecasts which reflect 1952 operating data rather than the carrier's more recent operating results.[144] Based upon the foregoing conclusions and all the facts of record, we find TWA has a mail pay need of $4,281,000 for a future annual period starting January 1, 1954.

13061

Two matters warant further comment. First, it is to be noted that our determination of TWA's future mail pay need for its transatlantic operations has been made without regard to the possible offset of excess earnings of its domestic division. If at the conclusion of the pending further hearing on the offset issue, there should be found to be such excess earnings, they will be offset against such subsidy as the transatlantic service may require.

Second, it is to be noted that our rate order will provide that in no event will TWA receive less than a service mail rate. It may well be that at the current service rate for 1954,[145] and with the available excess earnings of the domestic division, if any, TWA's transatlantic operations will not require subsidy assistance in 1954. Moreover, there is a substantial possibility that if, as currently planned, the certificated carriers are used for the shipment of substantially all military mail, TWA's transatlantic operations for the period starting January 1, 1955, will be conducted without subsidy, whether or not the

---

144 For example of our similar action in other cases, see Colonial Airlines, Inc., Domestic Mail Rates, *supra*.

145 For the period January 1, 1954 through April 7, 1954, the service rate is 85 cents per mail ton mile. For the remainder of the year the rate is open, and is to be established in proceedings instituted by the Board in Docket No. 6630 by Order No. E-8231, dated April 7, 1954.

domestic division has available excess earnings for offset.[146]

13062

The Rate for PAA for the Period Beginning January 1, 1954

The Examiner, calculating PAA's future rate upon the assumption that the Board should continue to underwrite the cost of operating Boeing B-377 aircraft with a capacity of 61 seats, allowed PAA $7,177,000 in breakeven need, and recognized investment of $55,372,000 including $11,608,000 of working capital.

Each of these figures is in issue. Bureau Counsel challenge the Examiner's determination of breakeven need and investment, contending that PAA, with respect to its operations in comparable areas to TWA, should be limited to TWA's forecast breakeven need and investment.[147] PAA, although asserting that the Examiner's allowance of breakeven need is not fully adequate, is willing to accept it. PAA, however, argues that the Examiner erroneously calculated the working capital to which it is entitled, claiming that the Board should recognize an additional $3,400,000.

The Examiner concluded that under Bureau Counsel's position, PAA would either have to cease operating B-377

---

146 There remain certain areas of uncertainty which would preclude a firm conclusion that TWA's transatlantic operations will be conducted with only a service mail rate after January 1, 1955. Thus, we do not now know the exact amount of mail which will move across the Atlantic in 1955, nor have we yet set a final service rate for such mail.

147 Bureau Counsel's proposed future rate for TWA was based upon forecasts derived from 1952 operating data. We have used more recent data and have arrived at a lower mail rate for TWA. Comparison of PAA operating results for the same period indicates a similar improvement in PAA's breakeven need requirements, and we can perceive no reason why Bureau Counsel's proposed uniform treatment of PAA's operations in comparable areas to TWA's is affected by the change in the amount of mail pay involved.

aircraft or bear the excess cost of their continued operation. This position, the Examiner found, was inconsistent with Bureau Counsel's conclusion that PAA's action in purchasing the equipment was not improper. The Examiner noted that Bureau Counsel had not shown that PAA could dispose of such aircraft without loss, or proved that PAA's recent cost experience with the B-377 reflects uneconomic management. Therefore, he found that the B-377 was entitled to continued support.

13063

In this regard, PAA asserts, as it did in connection with the excess need issue, that there is no reason for fixing PAA's mail rate in relation to TWA's requirements. PAA further argues that Bureau Counsel's computation of PAA's need on the basis of TWA's requirements contains "numerous errors, which, if corrected, would bring the amount back to the breakeven need recommended by the Examiner".

Both TWA and the Post Office Department support Bureau Counsel's position that PAA should receive no more mail subsidy support than TWA for operations conducted in comparable areas.

After careful consideration of the views of the parties and the record in this proceeding, we have decided that for operations in comparable areas PAA should receive a uniform rate based upon TWA's.[148] The same standards of comparability upon which the Board based its decision in the *Big Four Case*[148a] warrant the establish-

148 While PAA's mail compensation for operations in comparable areas is based upon TWA's unit rate (i.e. rate per revenue ton mile), PAA will actually be paid under a higher unit rate which is derived from the operating requirements of both non-comparable and comparable areas. See page 115, *infra*.

148a American Airlines, Inc., et al., Mail Rates, supra. It is to be noted, contrary to PAA's contention, that the Board in this case established a uniform subsidy as well as a uniform service rate.

ment of a uniform rate for TWA and PAA for operations in comparable areas.[149] We find that providing PAA with the same unit rate of mail compensation as TWA for operations in comparable areas will enable PAA, when operated under the statutory requirement of honest, economical and efficient management, to meet its statutory need.

Our decision is based in substantial part upon the conclusion that PAA has not demonstrated that the continued operation of Boeing B-377 aircraft in the future as it was in the past period, is in conformance with the requirements of section 406 of the Act. Contrary to the Examiner's position, we do not accept the thesis that once prudently acquired, the Government is under an

13064

obligation to maintain an aircraft with subsidy until the natural end of its recognized depreciable life.[150] In our judgment, this thesis is inconsistent with the statutory requirements of section 406 of the Act.

As we pointed out in connection with our decision to support the initial operation of B-377 equipment by Northwest, the developmental purposes of the Act may warrant the subsidy support of new equipment even though its initial operating cost appears inordinately high. This, we said, was due to the fact that "high costs have been a concomitant of practically all new aircraft types upon their introduction." In the main, however, they turned out to be

149 See Appendix A, pp. 78-80.

150 It may be noted in passing that there is an apparent inconsistency between the posit' n of the Examiner and that which he took on the excess Constellation engine issue. Thus, he concluded on the latter issue that upon determination, after a reasonable period of time, that there were excess engines, PAA was under an obligation to dispose of them. He found that PAA had not satisfactorily demonstrated its inability to dispose of the excess engines without loss, and was therefore not entitled to further subsidy support for such engines.

a boon to the industry and the public, for within a reasonable time many difficulties were mastered, with subsequent decreases in costs of operation, and the greater revenue potential realized."[151] However, our opinion clearly indicated that in our view, unless such progress ensued, it would not serve the developmental purposes of the Act to continue to support such aircraft with mail subsidy.

It is now apparent that, despite the relatively high passenger acceptance of the B-377, it has not attained an operating cost level when operated in a luxury configuration which would result in a total mail pay requirement for the carrier as low as it would have experienced had it not operated such aircraft. As a matter of fact, the operation of B-377 equipment by PAA across the Atlantic has had, and would continue to have the dual effect of not only

increasing PAA's need but also of increasing TWA's required breakeven need to meet the greater passenger attractiveness of the B-377 as operated by PAA.[152]

With these facts in mind, we deem it appropriate as of December 31, 1953 (on which date we shall close the past period) to terminate subsidy support for operation across the Atlantic of B-377 equipment. This will have afforded PAA support for approximately four and one-half of the seven year depreciable life of the aircraft. While we recognize that the price paid in additional subsidy for Boeing B-377 operations in the period prior to January 1, 1954 is a high one, being in excess of sixteen million dol-

151 Northwest Airlines, Trans-Pacific Operations, Order No. E-7079, dated January 13, 1953, p. 10.

152 As we pointed out in connection with the selling expense issue, TWA faced a severe competitive problem in meeting the greater passenger attractiveness of the B-377 operated with limited seating which, in our judgment, justified the carrier in increasing its sales efforts, with a concomitant cost increase being met with an increased subsidy allowance in the past period.

lars more than comparable service would have cost in Constellation equipment, we believe that on the facts here involved, it is warranted as a reasonable experiment in air transportation. However, as Bureau Counsel point out, every experiment must end and a four and one-half year period for the support of operations having the indicated high additional subsidy requirements heretofore noted certainly accords the carrier fair treatment.

It is our opinion that even though we deny PAA the higher subsidy support which would be required for continued operation of the Boeing, PAA will have a fair opportunity to meet its breakeven need, and receive a fair return on its investment when operating under honest, efficient and economical management. As Bureau Counsel have suggested, the carrier has various opportunities for achieving this result.

13066

It is noteworthy that Pan American's transatlantic fleet includes a substantial number of Douglas DC-6B aircraft, which are recognized to be among the most efficient and economical aircraft ever utilized in long haul operations. Pan American has failed to establish that the advantages flowing from use of its DC-6B aircraft will not to a large extent compensate for the greater need arising from continued operation of the Boeing in the configuration heretofore utilized.

In addition, there may be other ways in which the carrier could meet its service responsibilities without disproportionate subsidy assistance. Thus it may be possible, by further improvements in the B-377 performance, to reduce the unit operating costs,[153] or to increase its already great

[153] As a matter of fact, the unit operating cost of the Boeing could be reduced without change in aircraft performance merely by increasing the number of available seats. In this connection, it may be noted that PAA operates the Boeing elsewhere on its system with 80 or more seats.

passenger attractiveness to obtain higher load factors. Either of these results would reduce the subsidy required for further Boeing operations, and make the aircraft more competitive in this respect with TWA's Constellation equipment. As a matter of fact, this course may have already been taken by PAA. Although the carrier did not place the information in the record, we note that PAA has recently advertised to the public that it has introduced into service Boeing aircraft equipped with modified engines and new propellers which, it is claimed, have given the aircraft greater speed and range. Obviously, to the extent that this change in aircraft performance may have reduced the extra operating subsidy heretofore required for the Boeing, PAA will be better enabled to continue Boeing service in the future without the

13067

need for the subsidy differential which we have recognized for such operations in the past period.

Finally, we do not believe that the carrier has succeeded in showing that it would be unable to dispose of the Boeings without loss. As Bureau Counsel point out, recent history has clearly demonstrated the ability of airline management to dispose of aircraft without loss and indeed in some instances, at substantial profits over book value. This fact has contributed substantially to their ability to re-equip with newer and more modern equipment of higher productivity. PAA has not come forward with any evidence which would support a contrary conclusion with respect to the Boeing. As a matter of fact, while the record contains no evidence as to market value of the B-377, we take official notice of the fact that since the close of hearing in the proceeding there has been a sale of six Boeing aircraft and spare parts by United Air Lines, Inc., to British Overseas Airways Corporation for a price of

$4,800,000,[154] which closely approximates the average book value of PAA's equipment as of December 31, 1953. It has also been indicated that PAA has negotiated a sale of a B-377 aircraft to BOAC at a comparable price upon which it has made a profit, according to reported figures, of almost $150,000. Such indications then of resale price as are currently available tend to support our view that PAA has not established its inability to dispose of them without loss.

In reaching our decision to terminate the additional subsidy support needed to meet the higher costs of operation of the Boeing B-377, we have not overlooked the impact of our decision on airline management. Thus, it

13068

has been pointed out to us that a considerable lead time is involved in arranging for a replacement program, and it has been suggested that, if we find an aircraft to be unsatisfactory, we are obliged to give the carrier sufficient notice of our view to permit the orderly replacement of the equipment. In the first instance, it should be apparent at this point that we cannot, nor do we wish to assume the function of management. This is obviously what would be entailed were we to assume the obligation of informing management of the disposition to be made of its equipment. On the other hand, the facts which have motivated our action were equally well known to the carrier. PAA made no secret of the fact that in actual operation, the Boeing failed to live up to its advance expectations insofar as performance was concerned. At such time as it became apparent that the aircraft would not produce as expected, management should have taken affirmative steps to offset

---

154 The contract price of the aircraft was reported to the Board by United and BOAC in the course of proceedings involving the exercise of our statutory authority under Section 408.

the effect of the increased subsidy required to operate this equipment.[155] It is no answer to this problem to point out, as the carrier has, the great passenger appeal of the B-377 when operated in a luxury configuration and the advantage it has given PAA in maintaining high load factors across the Atlantic.[156] The only satisfactory answer would be for the carrier to prove, as it has not done here, that it was reasonable for its management to believe that without the continued operation of B-377 in the configuration chosen by

13069

the carrier, its breakeven need would have been greater than it would otherwise be.

In other words, we are of the firm conviction that every carrier which requires subsidy support must make its management decisions after careful consideration of the effect they will have on the carrier's subsidy requirements. Factors of airline prestige or competitive advantage which may be of primary concern in management decisions in other industries must give way to the effect on required subsidy where the Government is called upon to furnish a substantial portion of the total cost of operation. Not only is such a policy necessary to protect the Federal treasury from an unwarranted drain, it is also necessary,

---

155 As Bureau Counsel note, if PAA had made a reasonable disposition of the Boeing aircraft at a loss, after it had been demonstrated that the Boeing could not achieve the economic benefits anticipated by the carrier at the time of purchase (See Appendix A, pp. 37-38), we would have stood ready to underwrite the loss.

156 Obviously, the fact that the B-377 as operated by PAA has great passenger appeal does not mean that its continued operation is an act of economical and efficient management any more than would the operation of Cadillac limousines as taxicabs necessarily connote sound business judgment on the part of a fleet operator. The Cadillacs may attract more business than would another vehicle—but the revenues gained thereby may not equal the added costs of service in the luxury car.

as TWA has pointed out, to preserve for the traveling public the inherent benefits of a competitive service. As we suggested in an earlier opinion in this proceeding, "• • • There is ever present in the process of financially underwriting air transportation, • • • the potentiality that the beneficial force of competition will be nullified by mail payments to individual carriers in amounts inconsistent with maintaining the desired competitive spur to efficiency in the air transport industry."[157]

With respect to recognized investment, PAA contends that Bureau Counsel err in recommending that PAA's investment in comparable areas, exclusive of working capital, be based upon TWA's.[158] PAA argues that a policy which would limit recognition of investment between competing carriers to that of the

13070

carrier with the least investment would inhibit carriers from buying new equipment and thus impede development of air transportation. This argument may have a surface appeal; however, it does not survive analysis. PAA's argument necessarily assumes that the acquisition of new aircraft must result in increased subsidy requirements because the greater cost of new aircraft inflates the carrier's investment base. However, this is clearly a false assumption since in the main, the operating economies and revenue potential resulting from new aircraft have ultimately more than offset the increased depreciation charges and capital cost entailed in their purchase.

It was the failure, after what we deemed to be a reason-

---

157 Order No. E-3880 et al., dated February 7, 1950, p. 7.

158 Bureau Counsel has computed PAA's investment in comparable areas with TWA on a uniform basis related to TWA's fixed capital investment per revenue ton-mile.

able experimental period, of the Boeing B-377 as operated by Pan American in the area here involved to attain such operating results which leads us to terminate further subsidy support therefor. PAA, however, further suggests that it now operates Douglas DC-6B's in the transatlantic area, which it purchased at a substantially higher cost than TWA's earlier purchased Constellations and that we should allow PAA a differential over TWA's rate based upon the greater initial cost of the Douglas equipment. However, as we have already indicated, the introduction into service of a new model aircraft such as the DC-6B does not necessarily result in an increased subsidy requirement for a carrier since the operating economies and revenue potential of such aircraft in comparison with older types are ordinarily more than sufficient to offset the capital cost and other expense increases involved. There is no evidence that the Douglas aircraft operated by PAA have not achieved this result. It may be noted that the Board, apart from the question of support of a new type of equipment on a limited experimental basis, has adopted a policy of recognition of the increased investment due to new equipment only where the

operating efficiencies to be derived therefrom are of such a nature as to permit the carrier to operate without increased subsidy requirements.[159]

PAA makes one further argument which warrants brief comment. PAA asserts that Bureau Counsel's calculation

---

159 Pan American-Grace Airways, Inc., Mail Rates, Order No. E-6555, dated June 27, 1952, p. 26-27, finalized by Order No. E-6872, dated October 14, 1952; Southwest Airways, Inc., Mail Rates, Order No. E-8659, dated September 28, 1954. Compare Pioneer Air Lines, Inc., Mail Rates, Order No. E-7225, dated March 13, 1953.

of its breakeven need in comparable areas based upon TWA's is replete with mistakes, and that, if properly calculated, PAA's breakeven need on this basis would actually be larger than the Examiner's recommended amount, which PAA is willing to accept. PAA has not supported its assertion with specific data, and the general subjects to which it refers as involving errors by Bureau Counsel appear to be matters of policy which have already been decided adversely to PAA's contentions. However, as the record in this case clearly attests, Bureau Counsel has at all times stood ready to listen to the carrier's views as to the appropriate application to the facts of the principles espoused, and to make whatever mathematical adjustments to figures which are warranted. We must assume that if the alleged errors were merely calculation matters, they would have already been called to Bureau Counsel's attention, and that appropriate action would have been taken thereon to so advise the Board.

We turn now to the matter of working capital. In our judgment, the same considerations which move us to base PAA's breakeven need and fixed investment in comparable areas on TWA's require that PAA's working capital be similarly computed so that a truly uniform rate is established insofar as comparable operations are concerned.

13072

Apart from the determination of the appropriate rate for PAA for the comparable areas, we must also establish the amount of mail pay for the non-comparable area. In so doing, we are applying to the determination of this amount the same basic technique as we applied in determining TWA's future rate. Thus, we have adjusted the reported break-even need for PAA's Atlantic Division in

accordance with the rate principles established in this proceeding to obtain the adjusted break-even need for the entire division for the 12 months ended September 30, 1954 (without regard to the question of uniform rate). In order to determine what portion of the adjusted divisional need relates to the non-comparable area, we have applied to such need the same ratio of break-even need between comparable and non-comparable areas as forecast by Bureau Counsel for the year 1953. On this basis, we determined that the recognized break-even need for the non-comparable area is $1,593,000.[160]

The determination of working capital and fixed investment for the non-comparable area is based upon a similar procedure. Thus, we have applied to the adjusted investment for the entire division as of December 31, 1953, the same ratio of investment between comparable and non-comparable areas as recommended by Bureau Counsel for the future rate.

One further matter should be mentioned. In establishing PAA's future rate we have given no consideration to the question of whether there are excess earnings available in other divisions of the carrier to reduce the need of the Atlantic Division. If at the conclusion of the pending further hearings on offset,[161] there should be found to be such excess earnings, they will be offset against such subsidy as the transatlantic service may require.

13073

Based upon the foregoing considerations, we find that PAA's Atlantic Division should receive for a future year

---

160 Appendix 11.

161 Order No. E-8672, *supra*.

(13073)

starting January 1, 1954,[161a] a mail pay rate based upon the following sums:

Comparable areas	(000)
Total mail pay based upon TWA's unit rate, which is equivalent to 5.74 cents per revenue ton mile, applied to estimated revenue ton miles of 75,887,000 for PAA in the comparable area	
sub-total	$4,354
Non-comparable areas	
Breakeven need	$1,593
Return on investment	1,167
Provision for federal income tax	1,037
sub-total	$3,797
Total	$8,151

161a PAA's reported figures for the nine months ended September 30, 1954 indicate that PAA has realised gains in that period of $577,000 through retirement of equipment. Accordingly, our order provides that PAA's subsidy for the year 1954 shall be reduced by this amount. Cf. Braniff Airways, Inc. Domestic Operations, Mail Rates, Order No. E-7780, dated October 1, 1953, p. 18; finalized by Order No. E-7928, dated November 27, 1953.

13074

Excess Earnings of Other Divisions

In our opinion of September 29, 1954, in which we reopened the record for further proceedings with respect to the offset issue, we left for later decision certain related policy questions. We shall now resolve these matters.

The first question relates to the proper application of Bureau Counsel's proposed increase from 5 to 15 percent in the recognized residual value for aircraft and engines.[162] Bureau Counsel suggest that TWA's reported aircraft and engine depreciation and investment accounts be adjusted, effective January 1, 1953, to reflect the Board's present policy of recognizing a 15 percent residual value for such equipment.[163] The net effect of Bureau Counsel's proposal is to reduce the depreciation allowance for such equipment by the full increase in residual value and spread such reduced allowance thereof over the useful life remaining after January 1, 1953. TWA, on the other hand, contends that the adjustment in residual value should be spread back into earlier periods dating from the initial use of the equipment. T.W. asserts that the reported depreciation for the domestic division in the 1947-1950 period for which we established mail rates retroactively should be reduced by $1,019,000 and the expenses of the subsequent period appropriately revised.

Thus, the carrier, in effect, seeks to increase its depreciation

---

162 As will hereinafter be indicated, this question becomes especially significant in view of our earlier decision herein (Order No. E-8672, *supra.*) to exclude from consideration of available earnings for offset purposes any periods of earnings deficiency in a period for which we established mail rates retroactively.

163 We are here concerned with the application of Bureau Counsel's proposal to TWA's domestic division. However, the same policy has been applied to the international division equipment.

expense recognizable for offset purposes by retroactively decreasing depreciation for a period which is closed for such purposes. Such a transfer of expense from a closed period to an open period has always been prohibited by the Board.[164] As a matter of fact, the Board in its earlier decision establishing mail rates for the Big Four, including TWA's domestic division, similarly limited its readjustment of the carriers' reported depreciation and investment accounts to the open rate period subsequent to the initiation of the proceeding.[165]

An additional matter in controversy between TWA and Bureau Counsel relates to the proper treatment of a $3,016,000 tax refund received by TWA in 1946.[166] TWA contends that since the refund is for taxes paid in 1944 and 1945, it should be so applied as to reduce its tax liability in these years. Thus, TWA would get the full benefit of the refund. Bureau Counsel contend that since it is clear that the tax refund was occasioned by TWA's 1946 operating losses and that such losses were in fact reduced by the refund, the Board should take into account only the net loss after taxes. The carrier notes that in the *Big Four Case* the Board, in exhibits summarizing United Air Lines' operating results in comparison with those of the other Big Four carriers, did not take account of the fact that in the 1947-1948 period United had received similar tax refunds. TWA contends that this illustrates the proper Board treatment of such tax refunds.

---

164 Continental Air Lines, Inc., Mail Rates, Order No. E-5934, dated December 11, 1951, finalized by Order No. E-5973, dated December 27, 1951.

165 American Air et al., Mail Rates, *supra*.

166 The parties have stipulated that in the event that the Board decides the refund should be credited to 1946, then $393,000 would be assignable to the period January 1-February 4, with the balance of $2,623,000 falling in the remaining months of the year.

It is apparent, however, that the mail rates established by the Board

13076

in the *Big Four Case* were not responsive to any decision on this issue. Under such circumstances, it is difficult to conceive of the *Big Four Case* as having established a binding precedent on the matter. On the other hand, we have on another more recent occasion considered the matter of the appropriate treatment for tax refunds, and concluded that we should apply such refunds to the period in which they were received, rather than permit the carrier to adjust retroactively its reported liability for taxes in a closed rate period.[167]

TWA has also proposed that we recognize as a proper expense the accruals to a reserve account established by the carrier for "normal" taxes, payment of which has been deferred through the use by the carrier of an accelerated amortization privilege provided by Section 168 of the Internal Revenue Code, as amended. We shall defer decision on this question for disposition with the remaining questions on offset upon which we have ordered further hearing.[168]

There is one further matter in connection with the determination of excess earnings upon which it appears desirable to render a decision at this time. This relates to an out-of-period adjustment of accounts between PAA and its affiliate, Panair do Brazil. Bureau Counsel contend that in 1953, subsequent to the establishment of the LAD final mail rate for the period 1948-1951, PAA credited surplus in the amount of $126,000, representing an adjustment pursuant to a settlement with Panair do Brazil, reducing PAA's

167 Northeast Air Lines, Inc., Mail Rates, Order No. E-7368, dated May 11, 1953, finalized by Order No. E-7443, dated June 8, 1953.

168 E-8672, supra.

share of expenses for certain joint facilities. Of this amount $73,000 relates to the closed rate period from April 1948—December 1951. This amount Bureau Counsel contend would have been applied against PAA's need for those years had the Board been apprised of the facts prior to the establishment of the rate. Ordinarily such an out-of-period adjustment is applied to the year or years to which it relates. However, we believe that Bureau Counsel's position with respect to the treatment of such out-of-period adjustments between carriers and their affiliates is sound, and that whenever revenues are received during an open rate period which relate to a closed period and are received from persons or corporations over which the carrier exercises a large measure of control, such revenues should be treated as revenues received during the open period.

Conclusion

In accordance with the foregoing findings we have made a final determination of the issues upon which are based fair and reasonable rates of mail compensation for PAA's and TWA's transatlantic operations in the period up to and including December 31, 1953, as well as for the future period on and after January 1, 1954. We have considered each of the parties' exceptions to the Initial Decision and, except to the extent otherwise indicated herein, find them without substantial merit.

We are issuing an appropriate rate order establishing the amount of mail compensation for TWA and PAA for both the past and future periods. Such order will provide a basis for payment for both carriers for the future period commencing January 1, 1954 and for TWA for the past period.

13078

We will, however, stay the effectiveness of the order, insofar as payment of mail compensation for PAA for the past period is concerned, until after final disposition of the pending proceeding on offset and the determination of the amount of excess earnings, if any, of PAA's other divisions. Since the future period rates herein established are substantially less than the amounts currently being paid the carriers under temporary rates (as well as TWA's past period rate), we shall not stay the effectiveness of these rates. It is to be noted that, if it is later determined that there are excess earnings of other divisions of these carriers available to reduce such subsidy as may be required for transatlantic operations, appropriate provision will be made in our order disposing of the offset issues to assure the repayment of these sums to the Government.

Since there is no offset issue raised in connection with AOA's mail compensation, our order will also be a basis of payment for AOA's operations.

On the basis of the foregoing considerations, we find that the fair and reasonable rates of compensation to be paid each of the carriers named below for the transportation of mail by aircraft over the routes described below, the facilities used and useful therefor, and the services connected therewith, are as follows:[169]

A. For American Overseas Airlines, Inc., over its entire system for the period January 1, 1946 to September 25, 1950, inclusive, the sum of $22,107,000;

13079

B. For Pan American World Airways, Inc., between the points between which the carrier has been, is

169 The allocation of mail pay to periods for administrative purposes is set forth in Appendix 12.

(13079)

presently or hereafter may be authorized to carry mail by its certificates of public convenience and necessity authorizing transatlantic operations to points in Bermuda, Europe, Africa and Asia.

(1) For the period January 1, 1946 to December 31, 1953, inclusive, the sum of $90,469,000;

(2) For each calendar month beginning on and after January 1, 1954, an effective rate per designated mile flown to be derived by dividing by the designated miles flown during the month an amount derived by obtaining the product of 49.00 cents times the scheduled miles flown during the month (not in excess of 45,575 miles times the number of days in the month), provided, however that:

a. For the calendar year 1954, the amount of mail pay computed in accordance with paragraph 2 above shall be reduced by the amount of $577,000; and

b. In no event shall the amount of mail compensation payable hereunder for each 12-month period ending each month on and after December 31, 1954, be less than the amount computed in accordance with the applicable service mail rate or rates, provided, further that, if for any such 12-month period, the aggregate service mail pay is equal to or exceeds the mail pay that would be produced under the rate formula in paragraph 2 above, then the total mail compensation for each month in such 12-month period shall be computed in accordance with the applicable service mail rate or rates.

13080

C. For Trans World Airlines, Inc., between the points between which it has been, is presently, or hereafter may be authorized to carry mail by its certificates of public convenience and necessity other than certificates authorizing (a) interstate air transportation as defined in the Civil Aeronautics Act, and (b) air transportation between the United States and terminal points in Canada,

(1) For the period February 5, 1946 to December 31, 1953, inclusive, the sum of $50,730,000.

(2) For each calendar month beginning on and after January 1, 1954, an effective rate per designated mile flown to be derived by dividing by the designated miles flown during the month an amount derived by obtaining the product of 30.00 cents times the scheduled miles flown during the month (not in excess of 39.096 miles times the number of days in the month); provided, however, that in no event shall the amount of mail compensation payable hereunder for each 12-month period ending each month on and after December 31, 1954, be less than the amount computed in accordance with the applicable service mail rate or rates, provided, further that, if for any such 12-month period, the aggregate service mail pay is equal to or exceeds the mail pay that would be produced under the foregoing rate formula, then the total mail compensation for each month in such 12-month period shall be computed in accordance with the applicable service mail rate or rates.

For the purposes of sections B and C above, the rates per designated mile flown shall be applied to and the designated miles flown shall be computed on the direct airport-to-airport mileage between the points served for the carriage of mail on each trip flown on a schedule designated or ordered to be established by the Postmaster General for the carriage of mail; and the schedule miles flown shall be computed on the direct airport-to-airport mileage between the points actually served on each trip flown in scheduled service, including all trips operated as extra sections.

The compensation provided herein shall be in lieu of the mail compensation heretofore received by American Overseas Airlines, Inc., Pan American World Airways, Inc., and Trans World Airlines, Inc., for the respective services and periods covered herein; provided, however, that

(a) The payment of mail compensation hereunder for Pan American World Airways, Inc., for the period January 1, 1946-December 31, 1953, inclusive, shall be stayed pending final determination in the reopened offset proceeding instituted by Order No. E-8672 of September 29, 1954; and

(b) The compensation determined herein for Pan American World Airways, Inc., and Trans World Airlines, Inc., is subject to such adjustment as may be required by the Board's final determination in the reopened offset proceeding instituted by Order No. E-8672 of September 29, 1954.

An appropriate order will be entered.

Gurney, Chairman, Denny, Vice Chairman, Ryan, Lee and Adams, Members of the Board, concurred in the above opinion.

13082

Order No. E-8833

UNITED STATES OF AMERICA

CIVIL AERONAUTICS BOARD

WASHINGTON, D. C.

Adopted by the Civil Aeronautics Board
at its office in Washington, D. C.,
on the 20th day of December, 1954

Docket No. 1706 *et al.*

In the matter of the

TRANSATLANTIC FINAL MAIL RATE CASE

ORDER

A full public hearing having been held in the above-entitled proceeding and the Board, upon consideration of the record, having issued its opinion containing its findings, conclusions and decision, which is attached hereto and made a part hereof;

IT IS ORDERED:

1. That the fair and reasonable rates of compensation to be paid each of the carriers named below for the transportation of mail by aircraft over the routes described below, the facilities used and useful therefor, and the services connected therewith are set forth in paragraphs a through d below.

(a) For American Overseas Airlines, Inc., over its

entire system, for the period January 1, 1946 to September 25, 1950, inclusive, the sum of $22,107,000;

(b) For Pan American World Airways, Inc., between the points between which the carrier has been, is presently or hereafter may be authorized to carry mail by its certificates of public convenience and necessity authorizing transatlantic operations to points in Bermuda, Europe, Africa and Asia;

(1) For the period January 1, 1946 to December 31, 1953, inclusive, the sum of $90,469,000;

(2) For each calendar month beginning on and after January 1, 1954, an effective rate per designated mile flown to be derived by dividing by the designated mile flown during the month an amount derived by obtaining the product of 49.00 cents times the scheduled miles flown during the month (not in excess of 45,575 miles times the number of days in the month): *Provided, however,* that:

13083

a. For the calendar year 1954, the amount of mail pay computed in accordance with paragraph 2 above shall be reduced by the amount of $577,000; and

b. In no event shall the amount of mail compensation payable hereunder for each 12-month period ending each month on and after December 31, 1954, be less than the amount computed in accordance with the applicable service mail rate or rates, provided, further that, if for any such 12-

month period, the aggregate service mail pay is equal to or exceeds the mail pay that would be produced under the rate formula in paragraph 2 above, then the total mail compensation for each month in such 12-month period shall be computed in accordance with the applicable service mail rate or rates.

(c) For Trans World Airlines, Inc., between the points between which it has been, is presently, or hereafter may be authorized to carry mail by its certificates of public convenience and necessity other than certificates authorizing (a) interstate air transportation as defined in the Civil Aeronautics Act, and (b) air transportation between the United States and terminal points in Canada,

(1) For the period February 5, 1946 to December 31, 1953, inclusive, the sum of $50,730,000.

(2) For each calendar month beginning on and after January 1, 1954, an effective rate per designated mile flown to be derived by dividing by the designated miles flown during the month an amount derived by obtaining the product of 30.00 cents times the scheduled miles flown during the month (not in excess of 39.096 miles times the number of days in the month); provided, however, that in no event, shall the amount of mail compensation payable hereunder for each 12-month period ending each month on and after December 31, 1954, be less than the amount computed in accordance with the applicable service mail rate or rates; Provided, further that, if for

any such 12-month period, the aggregate service mail pay is equal to or exceeds the mail pay that would be produced under the foregoing rate formula, then the total mail compensation for each month in such 12-month period shall be computed in accordance with the applicable service mail rate or rates.

13084

(d) For the purposes of paragraphs (b) and (c) above, the rates per designated mile flown shall be applied to and the designated miles flown shall be computed on the direct airport-to-airport mileage between the points served for the carriage of mail on each trip flown on a schedule designated or ordered to be established by the Postmaster General for the carriage of mail; and the scheduled miles flown shall be computed on the direct airport-to-airport mileage between the points actually served on each trip flown in scheduled service, including all trips operated as extra sections.

2. That the compensation provided herein shall be in lieu of the mail compensation heretofore received by American Overseas Airlines, Inc., Pan American World Airways, Inc., and Trans World Airlines, Inc., for the respective services and periods covered herein; Provided, however, that

(a) The payment of mail compensation pursuant to this order for Pan American World Airways, Inc., for the period January 1, 1946-December 31, 1953, inclusive, shall be stayed pending final determination in the reopened offset proceeding instituted by Order No. E-8672 of September 29, 1954; and

(b) The compensation established herein for Pan American World Airways, Inc., and Trans World Airlines, Inc., is subject to such adjustment as may be required by the Board's final determination in the reopened offset proceeding instituted by Order No. E-8672 of September 29, 1954.

By the Civil Aeronautics Board:

/s/ M. C. MULLIGAN

M. C. Mulligan
Secretary

(SEAL)

8251-42

13085

APPENDIX A

Excerpts from the Initial Decision of Examiner R. Vernon Radcliffe, in the Transatlantic Final Mail Rate Case, Docket No. 1706 et al.

This proceeding is concerned with the determination of fair and reasonable rates of compensation for the carriage of mail by three certificated air carriers engaged in transatlantic operations.

American Overseas Airlines, Inc. (AOA), and Pan American World Airways, Inc. (PAA), have previously had final mail rates established for operations through the calendar year 1945.[1] The past period for which rates must now be set accordingly begins, for these two carriers, with the calendar year 1946. Trans World Airlines, Inc.

---

1 AOA—Order No. E-2247, November 29, 1948; *Pan Am. Airways, Inc., Transatlantic Mail Rates*, 8 C.A.B. 267 (1947).

(TWA), inaugurated its transatlantic operations on February 5, 1946, and the rate to be set herein will be effective from that date as to TWA. Fair and reasonable future rates of mail compensation are also in issue. Temporary mail rates, revised from time to time, have been in effect for each of the carriers for the period here under review.[2]

Tentative final mail rates for each carrier have been proposed by the Board in Statements of Tentative Findings and Conclusions, accompanied by Orders to Show Cause[3] why such rates should not be adopted. In each case the carrier made formal objection to the rate proposed. With respect to the mail rate for AOA for the period 1946 through 1948 a limitation of issues was agreed upon in a prehearing conference held October 11, 1950. Upon petition filed by TWA, the Board, in January 1952, ordered consolidation of the pending mail rate cases of the three carriers.[4]

13086

Intervention with respect to all matters has been granted the Postmaster General and intervention limited to certain specific issues was granted for Seaboard & Western Airlines, Inc., and Air Line Pilots Association, International. After due notice to interested parties and the public a

---

2 *American Overseas Air., Mail Rates*, 7 C.A.B. 623 (1946), 8 C.A.B. 947 (1947), 9 C.A.B. 942 (1948), 10 C.A.B. 955 (1949), Order No. E-3724, December 19, 1949. *Pan Am. Airways, Inc., Transatlantic Mail Rate*, 7 C.A.B. 605 (1946), 8 C.A.B. 977 (1947), 9 C.A.B. 943 (1948), 10 C.A.B. 953 (1949), 10 C.A.B. 965 (1949), Order No. E-4969, December 27, 1950. *Transcontinental & W. A., Transatlantic Mail Rate*, 7 C.A.B. 421 (1946), 8 C.A.B. 975 (1947), 9 C.A.B. 962 (1948), 9 C.A.B. 963 (1948), 10 C.A.B. 803 (1949), Order No. E-6393, May 5, 1952.

3 AOA—Order No. E-2731, April 19, 1949.
Order No. E-3880, February 7, 1950.
PAA—Order No. E-2728, April 19, 1949.
Order No. E-3881, February 7, 1950.
TWA—Order No. E-3028, July 20, 1949.

4 Orders Nos. E-5999, January 2, 1952, and E-6061, January 28, 1952, consolidated Dockets Nos. 1706 (PAA), 2375 (TWA), 1666 and 4021 (AOA).

public hearing was held in Washington, D. C. A formal request was made for an initial decision by the Examiner in the course of the hearing. All parties have been afforded opportunity to file briefs to the Examiner.

General

PAA was the first U.S. air carrier certificated for transatlantic service, which authority was granted in May 1939.[5] The terminal points were New York, Marseilles and London via alternate routings, a northern one serving Shediac, Botwood and Foynes and a southern one including the intermediate points Horta and Lisbon. Initial services were operated with flying boats. During 1943-44 all of its transatlantic operations were conducted under contract with the Navy Department. Commercial operations resumed January 1, 1945. Decision in the *North Atlantic Routes Case*[6] was approved by the President July 5, 1945, adding U.S. co-terminals Chicago, Detroit, Washington, Philadelphia and Boston and extending the authorized routes beyond London to India.[7] Operations of PAA to points in Africa which were authorized on a temporary certificate or exemption basis to meet national defense needs[8] were extended on the basis of broader findings of public convenience and necessity in August

---

5 *Pan Am. Airways Co., Transatlantic Operations*, 1 C.A.A. 135 (1939).

6 *Northeast Air. et al., North Atlantic Routes*, 6 C.A.B. 319 (1945).

7 The certificated extension defined the route in terms of countries and geographical boundaries. The initial service pattern designated points of service as London, Brussels, Prague, Vienna, and beyond Vienna (a) Budapest, Bucharest, Istanbul, Ankara, Teheran, Karachi and Calcutta, and (b) Belgrade, Istanbul, Ankara, Beirut, Baghdad, Karachi and Calcutta.

8 See *Pan Am. Airways-Temp. Amend., U.S.-So. Am. Europe Op.*, 3 C.A.B. 256 (1942).

1946.[9] PAA held a "grandfather" certificate for New York-Bermuda service.[10] PAA's transatlantic operations in January 1946, the start of the review period, were conducted principally with Constellation and DC-4 aircraft Seven round trips per week were scheduled across the North Atlantic route to London; two additional trips weekly were scheduled over this route to Shannon and beyond Lisbon. New York-Bermuda frequency was 2½ round trips per week, with one bi-weekly round trip continuing to Lisbon. Lisbon-Dakar-Monrovia schedules called for 1 round trip per week.

13087

AOA was granted a temporary certificate authorizing transatlantic operations between New York and Lisbon in July, 1940.[11] A temporary certificate issued on the basis of national defense requirements was issued in December, 1941, authorizing it to operate between New York and Foynes.[12] AOA did not inaugurate service to Lisbon within the period of the temporary certificate. By the time it inaugurated service with flying boats to Foynes in June, 1942, it was operating under a contract with the Navy Department. Such contract services continued through 1944 and, like PAA, it returned to commercial operations across the Atlantic on January 1, 1945. During 1945 it changed from flying boats to DC-4 landplanes and as of January 1, 1946, the start of its review period, scheduled daily round trips between New York and Lon-

9 *American Overseas et al., South Atlantic Routes*, 7 C.A.B. 285 (1946). Certificated points were the terminal point New York, intermediate points the Azores, Dakar, Monrovia, Accra, and Leopoldville and the co-terminal Johannesburg and Capetown.

10 *Pan Am. Airways Co. (Del.) Grandfather Certificate*, 1 C.A.A. 422 (1939).

11 *American Export Air., Trans-Atlantic Service*, 2 C.A.B. 16 (1940).

12 *American Export Air Temporary New York-Foynes Ser.*, 3 C.A.B. 294, (1941)

don. In the *North Atlantic Route Case, supra,* AOA's certificated route was extended to points in northern Europe.[13]

TWA was a major transcontinental air carrier when it was certificated in the *North Atlantic Route Case, supra,* to embark upon commercial transatlantic operations.[14] It had engaged in extensive international operations under special contracts with the armed services during World War II. TWA inaugurated commercial transatlantic service on February 5, 1946, between New York and Paris. Initial service was with DC-4's, which were supplanted by Constellation aircraft as rapidly as the latter were received and ready for route service.

The extension of routes beyond the European gateway points in the post war period was accomplished during 1946 and the first half of 1947. Inauguration dates for the foreign terminal point were: for AOA, June 21, 1947, at Helsinki; for PAA, June 6, 1947, at Calcutta; and for TWA, January 8, 1947, at Bombay. Decision in the *North Atlantic Route Transfer Case,*[15] approved by the President July 11, 1950, transferred to PAA the

---

13 The certificate defined the route in terms of countries and geographical boundaries. The initial service pattern designated points of service as U.S. co-terminals New York, Chicago, Detroit, Washington, Philadelphia and Boston, intermediate points in Newfoundland, Labrador, Greenland and Iceland, Foynes, Glasgow, London, Amsterdam, Copenhagen, Stavenger, Stockholm, Berlin, Warsaw, Helsinki, Leningrad and the terminal point Moscow.

14 The certificate defined the route in terms of countries and geographical boundaries. The initial service pattern designated points of service as U.S. co-terminals New York, Chicago, Detroit, Washington, Philadelphia and Boston, intermediate points, a point in Newfoundland, Foynes, Paris, Berne, Rome, Athens, Cairo, Jerusalem, Basra, Dhahran, and the terminal Bombay. An alternate routing between Newfoundland and Cairo included intermediate points Lisbon and (a) Madrid and Rome and (b) Algiers, Tunis, Tripoli and Bengasi.

15 *North Atlantic Route Transfer Case,* 11 C.A.B. 676 (1950).

certificate and properties of AOA, added Paris and Rome to PAA's certificate, and added London and Frankfurt (until the Board shall find such service is no longer required in the interests of the American occupation of Germany) to TWA's international route. PAA took over the AOA operation on September 26, 1950. Decision of the Board in the *North Atlantic Certificate Renewal Case*,[16] approved by the President June 28, 1952, generally extended the certificates of TWA and PAA for their North Atlantic routes for a further period of 7 years. TWA's certificate was made permanent between New York and Rome via Newfoundland, Ireland and Paris. The condition relating TWA's service to Frankfurt to the requirements of the American occupation of Germany was removed; the Azores were added as an authorized service point between Newfoundland and Portugal; Italy was added between Tunisia and Egypt, and Kuwait was certificated for service between Iraq and Saudi Arabia. U.S. co-terminals Washington and Baltimore were dropped from both TWA's and PAA's certificate. PAA was authorized to add the intermediate points Nice between Barcelona and Marseilles, and to add Lisbon and Casablanca on its south Atlantic route between the Azores and Dakar, the latter authorizations being limited to August 14, 1953, the expiration date of PAA's South Atlantic route certificate.

As was previously noted, each of the three carriers used DC-4 and Constellation aircraft (L-49 model) for their operations at the start of the review period. TWA has twice replaced the early Constellations in its international fleet with later models; in 1948 with the L-749, and in 1950 with the L-749A. Both AOA and PAA added a substantial number of Boeing Stratocruisers (B-377) to their fleets in

16 Orders Nos. E-6560, E-6561 and E-6562, approved June 28, 1952.

1949-50. Major events within the review period directly affecting aircraft operations were the grounding of the Constellations in July, 1946, which kept them out of operation for approximately 2½ months, a TWA pilot strike in October-November, 1946, which lasted 26 days, and an AOA pilot strike in September-October, 1947, which lasted 19 days.

In terms of traffic, the period under review has been one of substantial and continuing growth. Scheduled revenue ton-miles reported for the combined U. S. carriers were as follows:

Calendar Year	'46	'47	'48	'49	'50	'51	'52
Ton-miles (millions)	47	92	99	114	122	126	145
Index (1946 = 100)	100	196	211	243	260	268	309

Despite a well defined seasonality of traffic movement, high in summer, low in winter, each of the carriers averaged load factors in excess of 60 percent for the over-all review period. More detailed data relating to traffic and operations is set forth in Appendix A

13089

In consolidating the pending transatlantic mail rate cases of AOA, PAA, and TWA into one proceeding for hearing and decision the Board indicated that a comparison of the several carriers against each other would aid in the determination of fair and reasonable rates of mail compensation. The order of consolidation was not a finding that the carriers were comparable in every respect and recognized that to the extent that material differences not subject to managerial control exist, the rates must reflect such differences. Thus, the Board did not contemplate that there would be found as between the carriers and

routes herein concerned such an equality of economic opportunity as to make it appropriate and desirable to establish them as a group, or class, with a uniform mail rate, such as was done for the Big Four domestic air carriers.[17] No party contends that there should be such a "uniform rate." However, care must be taken to distinguish between the broad question of whether there exists such an equality of economic opportunity as to justify a "uniform rate" and the question of whether, in a given area of operations, there exists such comparability as between two or more air carriers to justify the use of the experience of one of them as a test of the economy and efficiency of the other(s) in that area. This latter use of comparative results is the utilization of the "yardsticks" creation of which was stated by the Board to be one of the greatest gains to result from international competition between U. S. air carriers,[18] and for which purpose these three mail rate cases were consolidated into one proceeding.

Much of the evidentiary record is devoted to data and testimony proposing adjustments or disallowances on the basis of such comparisons, and, in opposition thereto, in ferreting out and weighing subsidiary points of incomparability for an offsetting allowance. As the Board pointed out in the *Big Four Case*:

> "We necessarily come to judge the performance of carriers after that performance has taken place. As a practical matter, unless we resort to comparisons among carriers as to certain costs and employ statistical methods, there is no way of enforcing the standards of economical and efficient management set out in the Act. We are satisfied that the com-

17 Order No. E-5560, July 31, 1951, affirmed by Order No. E-5715, September 19, 1951.

18 *North Atlantic Routes Case, Supra*, p. 325.

parative method is sound once reasonable precautions have been taken to allow for differences in essential characteristics of the carriers compared." (p. 16)

• • • this initial decision will consider the case with respect to each carrier separately. To the extent that there are issues common to two or more carriers they will be covered in connection with the first carrier considered with distinction drawn, if found, in relation to the carriers subsequently considered.

American Overseas

The mail rate period for AOA for which a rate must be established starts January 1, 1946, and ends September 25, 1950. As was previously

13090

noted a separate prehearing conference with respect to this carrier's rate was held prior to the Board's order consolidating the three pending rate cases. That conference resulted in a substantial limitation of the issues.

It is the position of Bureau Counsel that AOA's break-even need for the entire period totals $14,113,000. AOA opposes certain disallowances and deferrals incorporated in that result and contends that a proper disposition of the items in issue would increase the total break-even need by approximately $1,391,000. AOA requests a rate of return on investment greater than the 7% which has been set by the Board in prior cases relating to past periods.

(13090)

Excess B-377 Aircraft

• • • •

AOA received its first B-377 in June, 1949, with delivery of others to a total of 8 spaced to January, 1950. It started them in revenue service in the latter part of August, 1949, when it had received 3 of them from the manufacturer. Revenue utilization varied from a low of 1.5 hours (per plane per day) in August, 1949, to a high of 5.3 hours in June 1950. Bureau Counsel's proposal to disallow depreciation and hull insurance expense and investment related to 2 of the 8 aircraft is based on the approach that AOA failed to schedule its B-377's to achieve a reasonable utilization; that proper scheduling should have yielded utilization of not less than 6.5 hours during the off season (October-March) and 7.0 hours in the peak season (April-September). • • •

• • • •

AOA concedes that the utilization, which it was able to realize on its B-377's, was below the level it had anticipated for the aircraft. It presented testimony to establish that this plane, new to transport service in 1949, was a large and complex aircraft, incorporating many new advances in its operating systems and powered by the newest and largest reciprocating aircraft engines then produced. Substantial problems relating to maintenance of these engines and systems were encountered which required heavy and protracted programs of preventive maintenance and modification. AOA attributed most of the under utilization to these problems which, it asserts, were common to all operators of this aircraft. In addition AOA submits that the airport situation at New York also hampered maintenance activity and contributed to the under utilization. Subsequent to AOA's contracting for the B-377's the Port of New York Authority imposed gross weight limits on La

Guardia Airport which made it impossible to operate the B-377 from that field in revenue service. Lease controversies between the airlines and the Authority relating to facilities at the Idlewild Airport delayed the completion of AOA's hangar and shop facilities at that airport until early

13091

September 1950.[20] Thus the carrier lost time on New York turnarounds in ferrying B-377s between Idlewild and La Guardia Airports for maintenance. AOA points out that while it did not cut back its total transatlantic schedules following the lease of the B-377 in July or the accident which took another out of service in August, it was necessary to cut the B-377 frequencies, substituting L-49 flights, and further, that it had a substantial number of flight cancellations in August and September.[21]

• • • •

Under utilization of B-377 Aircraft.

As to the remaining six B-377 aircraft used by AOA Bureau Counsel contends that the computed utilization was still below the reasonable level of 6.5 hours off-season and 7 hours on-season from August, 1949, through March, 1950, and that appropriate portions of the depreciation relating to the under utilized aircraft should be suspended and hull insurance capitalized and amortized over a 5-year period. The related investment would not be recognized for rate purposes, but there would be allowed a capitalized interest on this investment which is treated as an added cost of

---

20 Nose docks, adequate for certain routine maintenance, were available to AOA at Idlewild in the Spring of 1950.

21 Schedule completion for PAA and TWA ranged between 97.0 and 98.7% for the period June-September, 1950. AOA's schedule completion was: June—92.4%, July 98.3%, *August* 89.5% and *September—90.0%*.

the aircraft and charged to expense through subsequent depreciation. These principles have been established in prior mail rate decisions[23] and AOA does not contest their propriety except in one respect. Under Bureau Counsel's proposal the deferred depreciation is to be "tacked on" to the end of the established 7-year period. Counsel for AOA contends that this under utilization and its attendant excess charge against depreciation which occurs when new aircraft are put into revenue service is properly a part of the cost of integration which should be capitalized and amortized over a 5-year period. AOA raises the issue and, in effect, urges revision of the prior policy for the reason that Bureau Counsel has in this proceeding proposed an upward revision to 15% of residual values of aircraft and engines.[24] An increase of residual value from 10 to 15% is equivalent to an extension of the 7-year depreciation period by about 5 months. The depreciation to be "tacked in" because of the early under utilization amounts to approximately 2 months for each of the six B-377s concerned.

Counsel for AOA submits that the depreciable life of current aircraft is based primarily on obsolescence, not on wear and tear; that the size and complexity of the B-377 give it an extremely limited secondary market, and that the resale value in 1956 (7 years) will be the same whether it had four or eight hours a day utilization in 1949-1950.

13092

All parties are agreed that transport aircraft, maintained, overhauled and modified under the strict standards established for air carrier operations, do not wear out.

---

23 *Braniff Airways, Inc., Mail Rates*, 9 C.A.B. 607 (1948); *Northwest Airlines, Inc., Domestic Operations, Mail Rates*, Order No. E-6338, April 18, 1952; *Western Air Lines, Inc., and Inland Air Lines, Inc., Mail Rates*, Order No. E-4870, November 24, 1950.

24 Residual values previously established have not exceeded 10%.

Their decline in value with the passage of time is related essentially to obsolescence—the availability of a new aircraft so superior in speed, comfort or economy that the earlier model or type cannot effectively compete with it. If, upon the introduction of a new aircraft to transport service, the date when it would become obsolete could be accurately foreseen, then the depreciation period should be fixed accordingly; and if, at the same time, the value of the aircraft for resale and use in a secondary market could be forecast, that would fix a proper residual value. But unfortunately such precise advance predictions are not possible and the Board and the industry must lean heavily upon judgment, weighing all aspects of past experience and all presently known facts bearing upon the future.

The present standard 7-year period of depreciation for aircraft produced in the period following World War II was adopted as such aircraft came into service and represented the best judgment of the Board and the industry at that time. The 7-year period was a substantial increase over the 3 to 5 year periods which had previously been in effect for the earlier DC-3's, DC-4's and other pre-war transport models. The fact that the DC-3's, then about 10 years in transport service, and the DC-4's with about 5 years of transport use, mostly military, had then good prospect of further useful commercial life doubtless contributed to that judgment. On the other hand, the intervention of World War II, with the attendant halt of civil aircraft production, would serve to label the period as abnormal and indicate a need for caution in increasing the depreciation period.

In this proceeding no party has urged that there be a revision of the basic 7-year depreciation period for post war aircraft. But Bureau Counsel has referred to intervening experience indicating probable conservativeness in the 7-year figure in support of his proposed "fringe ad-

justments" of that depreciation period. Since the post war period when the 7-year depreciable life was established there has now been added almost 7 years during which the DC-3's and DC-4's have continued in useful transport service. The post war L-49's, generally introduced in 1946, have now seen 7 years of service and are still in revenue operations with no sign that they will become obsolete in the near future.[25] That PAA considers its B-377's as its best competitive aircraft in the transatlantic market is indicated by its retention for deluxe and regular service while introducing the later manufactured DC-6B in tourist service. The only evidence offered by PAA

indicating a possible future obsolescence of the B-377 in transatlantic service is that it has on order 3 jet transport deHaviland Comet III's for delivery by the end of 1956, with an option to purchase an additional 7. Even if the contract date is met the new aircraft would require several months for proving, training and integration into the carrier's operations. Three of them could not replace PAA's B-377 fleet and no delivery date exists with respect to the 7 on option. Thus the earliest possible indicated obsolescence of the B-377 in transatlantic service is approximately 8 years from the date they started service in April, 1949. A more reasonable prospect is that the jet transports, when put in service, will take over the deluxe flights, probably with a fare premium, and that the B-377's will continue for some time in regular service, or, with higher seating density, in tourist service. Thus, on the basis of such evidence as is of record, it is clear that the present 7-year period for depreciation of post war aircraft is con-

[25] Bureau Counsel cites a recent sale of two such aircraft by PAA at a price of $937,500 each, approximately 6.5 times the proposed residual value of 15%.

servative and that the relatively minor fringe adjustments proposed by Bureau Counsel are reasonable and proper to reflect presently available experience and information bearing upon depreciable life and residual values and to avoid excessive write-off of equipment value in the early service period of limited productivity.[26]

Pilot Strike

From September 30 through October 17, 1947, AOA's pilots were on strike. Bureau Counsel takes the primary position that strike losses are to be borne by the carrier as a risk covered by the return on investment. Such position is not concerned with whether the strike resulted from proper or improper management. The carrier[27] contend that they are entitled to need mail pay to cover strike losses unless it is found that such losses resulted from dishonest, ineffcient, or uneconomical management. AOA submits that it has established that management was not at fault and that the proposed disallowance of $598,000 should be reversed.

The Board has not previously had occasion to decide such an issue. However, in a Statement of Tentative Findings and Conclusions issued April 19, 1949[28] in this docket it set forth a tenative position similar to that now urged by Bureau Counsel, as follows:

> "Costs attributable to strikes are neither normal nor recurrent in nature. However, the risk of such poten-

26 Depreciation expense to be disallowed totals $175,458. Hull insurance to be capitalized and amortized over a 5-year period is $91,933. Investment not recognized is $541,678 in 1949 and $960,813 in 1950. Capitalized interest on this investment will be allowed and added to the aircraft value to be depreciated.

27 TWA is faced with the same issue because of a pilot strike in 1946.

28 Order No. E-2731, proposing rates for the years 1946-1948.

tial cost is present in all industrial enterprises, including the air transportation industry. But costs of this nature are neither predictable nor capable of accurate measurement on a prospective basis. No accurate prediction can be made as to the incidence of the cost with respect to a particular company although the risk that such cost may be incurred exists in the case of all companies. The unpredictability of a contingency such as this establishes it as one of the risks of doing business to be

13094

reflected as part of the cost of capital rather than as a normal cost of operations.

"The existence of such elements as cost of capital in this industry has been recognized by providing a rate of return substantially higher than going interest rates. Such a rate of return has been allowed notwithstanding the substantial protection extended to air transportation under the Act to cover the operating requirements of the carriers under honest, economical, and efficient management. It follows that to provide in the mail rate for a rate of return at a level which reflects substantial risks to capital invested in the industry and at the same time to provide for direct reimbursement of the costs from all such risks as they materialize, would result in double provision in the mail pay for such risks. All risks which are real represent contingent costs of doing business and must be reflected either as recurrent operating expenses or as recurrent costs of capital. If they become sufficiently predictable to be susceptible of actuarial measurement they are properly reflected in operating expenses as insurance expense. Otherwise they will

be reflected as a cost of capital. They may not properly be reflected as both."

On brief Bureau Counsel cites the *Braniff Mail Rate Case* of 1948[29] and its treatment of aircraft grounding costs in support of this position. That decision employed much the same language as is quoted above in holding that the cost to Braniff resulting from the grounding of its DC-6 aircraft was a risk to be met out of its return on investment. * * * In any event, the treatment of strike losses proposed by Bureau Counsel is opposed by AOA and presents a question not previously decided by the Board.

AOA submits that the position of Bureau Counsel is directly violative of the standards of section 406(b) of the Act in that it would deny a carrier need mail pay occasioned by a strike without any determination of whether this need arose in the exercise of honest, economical and efficient management or from the fault of the carrier. AOA contends that the pilot strike was entirely without notice and beyond AOA's ability to avoid except by acceding to unreasonable demands. It submits that its need for the period arose from proper management action and should be allowed as reported. Decision of the Interstate Commerce Commission in an investigation proceeding instituted by the Commission is cited as establishing that extraordinary costs attributable to a strike are proper expenditures for rate-making purposes under statutory language similar to section 406(b).[31] In that case the New Haven Railroad Company had contracted for outside repairs of locomotives at the time of a shop strike in 1922. The cost of such outside repair work was found to

29 *Braniff Airways, Inc., Mail Rates*, 9 C.A.B. 607 (1948).

31 *Construction and Repair of Railway Equipment—New York, New Haven & Hartford Railroad Company*, 107 I.C.C. 721 (1926).

be substantially in excess of the company's experienced cost for similar work done in its own shops. The Commission held that "Under such circumstances prudent management could not be criticized for anticipating future needs and providing for them, even at increased cost if the best terms available were secured." The decision on this strike aspect of the investigation is emphasized by a further finding that other excessive costs of outside repairs incurred in a later period when its own shop had returned to normal activity were

13095

"improvident and of a character which should be considered when fixing rates to yield the standard as provided by the Act." Perhaps the most significant aspect of that decision for present purposes is the complete absence of any language indicating an endeavor by the Commission to assess possible fault for the strike. The existence of the strike was noted purely as a fact. The Commission's concern was with the propriety of management's subsequent action in meeting the factual situation thus created. TWA on brief cited a decision of the Public Service Commission of Missouri,[32] which similarly evidenced no concern over possible fault in connection with a 4-month strike of telephone workers which gave rise to expenses of $250,000. The Commission therein amortized the amount over a 5-year period.

Bureau Counsel argues that its position is supported by certain further policy considerations relating to labor controversies: that the Board should not hazard the virtually impossible task of deciding the issue of fault and, if it does so, that it will become the pivotal force in air

32 *Public Service Commission of Missouri* vs. *Southwestern Bell Telephone Company*, 8 Public Service Commission Reports (Missouri) 487 (1919).

carrier labor controversies. The Air Line Pilots Association, International (ALPA) in a written statement of position submitted during the course of the hearing[33] also stressed that the question of fault in labor dispute "is always controversial and usually impossible of accurate proof." The sense of the ALPA position is that the Board by underwriting with mail pay the strike losses of air carriers would support management with the weight of the Federal Treasury and thus throw out of balance the free play of economic forces and the effectiveness of labor legislation carefully drafted by the Congress over many years. The carriers present the other side of this picture, contending that to refuse all recognition of strike costs would put management in a position where it could not afford to resist union demands, would incur higher wage costs and in turn require larger amounts of need mail pay.

With respect to Bureau Counsel's position that the 7% rate of return used for past periods covers the strike loss risk, AOA points out that the proposed disallowance of $598,000 for an 18-day strike would reduce its return on investment for that year to 3%. The Board's past practice of setting different rates of return for past and future periods, 7% and 10% respectively, is premised on the theory that in a review of any past period the carrier is *not* bearing the risk of contingencies.

• • • •

There is ample evidence of record to sustain the contention of ALPA that an attempt to determine responsibility for a strike is always controversial and usually impossible of accurate proof. By its very nature labor-management bargaining involves the assertion of demands or the offer

---

33 Though ALPA was made a party through grant of its petition to intervene with respect to the strike issue it entered no appearance at the hearing.

of concessions on a bargaining basis, neither of which necessarily coincides with the ultimate terms of settlement. Procedures, personalities and substance may become inextricably interwoven and incapable of separate

13096

evaluation. Thus in the AOA case at hand the carrier has established, with respect to the substantive issue, that the ultimate terms of settlement agreed with an offer made by management prior to the strike. Yet, on the other hand, Bureau Counsel cites other evidence relating to the selection of the negotiating representative for the carrier, limitations on his authority, and failure of the carrier to initiate meetings which might have avoided or cut short the strike as indicating that the carrier did not make every reasonable effort required of it. Again, the passage of time since the negotiations occurred dimmed the memory of witnesses on this issue. Many details were beyond recall. Several witnesses were not present at the crucial negotiating sessions and testified only from old files and hearsay. While such problems may have been aggravated in this case because of the substantial time which has elapsed, it is believed that the basic difficulty is one that would always be present—trying to reestablish at some later date the significant factors, tensions, actions, inactions and innuendoes that led to a past strike.

The only cases cited by the parties as precedent on the question of allowing strike costs in regulated rates date back to about 1920. Much of the existing law relating to labor disputes has been enacted since that time to establish, as ALPA suggests, appropriate checks and balances between management and labor. Such subsequent legislation, with the additional procedures and remedies therein prescribed, appear as added reasons why the Board should

avoid a collateral determination of strike fault in a rate proceeding.

• • • •

On the question of the reasonableness of AOA's actions to minimize expenses during the strike period there is no dispute. The evidence establishes that the strike began without significant advance notice, that dismissal notices were promptly issued, that employees were utilized on special or deferred work during the running of the dismissal notice period and that some utilization of facilities was realized on outside work.

• • • •

Undercollections:

Bureau Counsel is raising for the first time in this proceeding issues with respect to undercollections and overcollections. Amounts of undercollections claimed for AOA are $36,000.[37] An "undercollection" results from failure of the carrier, through error, to collect from a passenger or shipper the full amount called for by applicable tariffs for the carriage performed. Upon determination that collection efforts are not justified in view of small amounts involved, or upon failure of efforts made in other cases, the carriers have charged off the receivables representing undercollections to expense. Overcollections are the counterpart arising from

13097

inadvertent collection of excessive amounts. Inability to locate the person to whom refund should be made results in charging off the account payable to all other revenue.

---

37 Broken down by years the amounts are: 1948, $8,000; 1949, $16,000 and 1950, $12,000.

(13097)

In the case of AOA Bureau Counsel submits that overcollections for the years 1949-1950 amounted to $30,000.

Bureau Counsel recognizes that some such errors are bound to occur, but submits that since a charge which deviates from official tariffs is a violation of section 405(b) of the Act it would be sound policy to require the carrier to refund the expense of such errors. It is further noted that the selection, training, supervision and tenure of employees performing such functions are entirely within the control of the carrier and the contention is made that any policy of underwriting such losses would reduce the carriers' incentive to minimize such losses through closer supervision and control. Bureau Councel cites several cases arising under language of the Interstate Commerce Act similar to that of section 403(b) which have held that both the carrier and the shipper have a duty to collect or pay the proper tariff charges and that no inadvertent deviation therefrom can affect the obligation or rights of either party.[38] There is no question but that these decisions establish the right of the carrier to recover against the passenger or shipper for any undercollection and the right of the passenger or shipper to recover any overcollection. But Bureau Counsel contends that they establish an *absolute* obligation on a carrier to collect the exact tariff amount, no more and no less. If such an absolute obligation were here determined to be the necessary standard of honest, economical and efficient management under section 406 certain questions would follow which are not answered by Bureau Counsel. If to recover on an undercollection of a minor amount the carrier had to incur expense greater than the amount involved would the collection expense be recognized for mail rate purposes? Testimony of record indicates that the law in certain foreign countries does not accept the tariff as controlling.

---

38 *Nashville R. R.* v. *Maxwell*, 237 U. S. 94 (1915); *Berstein Bros. Pipe & Mach. Co.* v. *Denver & R.G.W.R. Co.*, 193 F. 2d 441 (1951).

Would the carrier's absolute obligation there extend to efforts to have the local law revised and would expenditures toward that end, regardless of amount, be recognized as a proper mail pay need? With respect to overcollections would there be reason to credit it in "all other revenue" at the same time insisting that the carrier's absolute obligation required it to expend funds without end to seek out the person overcharged until found and payment made? The answers to these questions are obvious. The standard of honest, economical and efficient management will not knowingly spend twenty dollars to recover ten.

AOA agrees that an overcollection or undercollection is a technical violation of section 403(b) of the Act, but also points out that sections 902 and 902(d) would subject such violations to criminal penalties only if the action were taken knowingly and willfully. No such actions are here in issue. AOA also concedes that an issue might arise under section 406 if it appeared that the amount of under or overcollections for a particular carrier or period were abnormally large. While Bureau Counsel has stressed his primary position of complete disallowance, he also relies upon testimony

13098

of PAA and TWA witnesses indicating that legal action has never been initiated to recover for undercollections, and testimony of PAA witnesses indicating some reluctance to press for undercollections for public relations reasons, as establishing that the carriers are not exerting reasonable efforts to minimize such expense. But if amounts involved are small (there is no evidence as to the amount of individual undercollections) then the failure to initiate suit for collection cannot be relied upon as conclusive of inefficiency. TWA's undercollections in issue for the years 1950-51 averaged about one one-hundredth of one percent

of non-U.S. mail revenues. Thus, if the average passenger sale amounted to $220.00,[39] the average passenger undercollection was 2.2 cents. Even if error were made on only one of each 100 passengers the indicated average of errors made would be $2.20. Certainly legal action to recover such amount, or several times that amount would not appear reasonable.

While the contentions of Bureau Counsel for complete disallowance of undercollections cannot be found proper under the standards of the Act, comparative consideration of the experience of AOA and PAA, as contrasted to that of TWA, indicates the propriety of disallowing a substantial part of such expense for the former two carriers. The following tabulation sets forth the amount of undercollections for the years in question as a percentage of non-U.S. mail revenue:

	Undercollections (000)	Revenue (000)	%
TWA ('50-'51)	9	72,517	0.0124
AOA ('48-'50)	36	52,464	0.0686
PAA ('47-'51)	172	180,078	0.0955

No evidence or contentions have been advanced which would support expenses for AOA and PAA in this category which are approximately 6 and 8 times as great, respectively, as those of TWA. In the light of TWA's results it is found that the undercollection expense of AOA and PAA, to the extent that it exceeds two one-hundredths of one percent, resulted from inefficient management and must be disallowed for mail pay purposes. The amount disallowed is $27,000 for AOA and $135,000 for PAA.

The contention of AOA that overcollections should be

[39] 1950 passenger revenue of $27,385,651 and 124,600 passengers indicates an average ticket sale of $219.79.

used to offset undercollections must be denied. Obviously the same inefficiency which leads to excessive undercollections can result also in excessive overcollections. Inefficiency should not be rewarded by permitting such offset. Since a reasonable level of undercollection expense is being underwitten with mail pay, the overcollections represent a windfall which should be included in all other revenues.

13099

Selling Expense:

Bureau Counsel has proposed a disallowance of a part of reported selling expense[40] of each of the carriers herein for some part of the past period. For AOA he recommends disallowance of $174,759 representing expenditures in excess of 19.5% of commercial revenues for the year 1949. Similar disallowances are proposed for PAA for the years 1949-1952, and for TWA for 1951 and 1952 in total amounts of $2,382,576 and $1,628,033, respectively. The Post Office Department urges that the disallowance be based on a 19.0% selling expense ratio, which was adopted by the Board for PAA's Latin American Division on review of its 1948-1951 operations.[41]

The basic concern of Bureau Counsel stems from the fact that expenditures for selling have consumed an increasing part of commercial revenues during the review period at the same time that such revenues and traffic density have been steadily increasing. The experience of the big four domestic carriers has been the reverse in this period. Bureau Counsel submits that the level of selling expense is substantially within the control of management and that the amounts it recommends for disallowance were unreasonably expended.

---

40 "Selling Expense" embraces all items reported in the 6400 and 6500 group of accounts, "traffic and sales" and "advertising and publicity."

41 Order No. E-7441, June 5, 1953, affirmed by Order No. E-7495, June 19, 1953.

(13099, 13100)

Basic data relating to the issue is as follows:

Transport Revenue[42]

(000,000)

	1947	1948	1949	1950	1951	1952
AOA	16.5	17.3	17.5	17.8	—	—
PAA	29.1	28.8	30.7	32.7	45.7	49.6
TWA	22.0	25.9	28.4	29.9	34.8	37.7

Selling Expense—% of Transport Revenue

	1947	1948	1949	1950	1951	1952
AOA	17.8	18.1	20.5	19.0	—	—
PAA	17.4	18.8	20.2	22.1	20.5	21.1
TWA (Intl.)	15.9	16.7	17.3	19.9	22.0	22.3
AA	15.0	14.1	12.3	11.3	10.4	11.0
EAL	14.4	12.7	13.2	11.8	10.7	10.6
TWA (DOM)	17.7	17.0	16.7	14.3	12.5	12.5
UAL	16.7	14.8	13.1	12.4	12.4	12.5

13100

The level of 19.5% of transport revenues recommended by Bureau Counsel as the cut-off point is admittedly a matter of judgment. Bureau Counsel's witness presented this figure as supported by considerations of comparative size, growth, traffic density, yields, load factors and competition as between these carriers and other U. S. air carriers both international and domestic. As between the three transatlantic carriers Bureau Counsel concludes that the only factor which merits a deviation from the 19.5% level is the competitive disadvantage suffered by TWA resulting from operation by AOA and PAA of the B-377 aircraft. An added ½ percentage point allowable selling

42 Transport Revenue excludes revenues from U.S. mail, foreign mail, all-cargo flights and non-scheduled operations.

expense is recommended because of this item, giving an allowable ratio of 20% for TWA.

AOA opposes any disallowance of its actual selling expenses for 1949. It submits that if proper correction is made to data employed by Bureau Counsel to correct erroneous allocations between domestic and international operations of TWA, and if Northwest's reported data for its international operations be excluded because of erroneous domestic-international allocation, then the average of 1949 selling expense ratios for the remaining international carriers becomes 20.5 percent, the same as AOA's experience. AOA further takes issue with the use of single calendar years for this purpose, contending that selling effort has a carry-over effect. On the basis of an averaged two-year analysis, 1948-1949 or 1949-1950, AOA had a selling expense ratio of 19.3% lower than comparable averages of PAA and TWA, or of all other international carriers. AOA also contends that Bureau Counsel has not given proper comparative weight to factors which his witness testified were significant—yield, trend of revenues and competition. On yield alone AOA points out that had its 1949 yield per passenger-mile been equal to TWA's experience, then its 1949 selling expense ratio would have been only 19.6% of transport revenues. AOA's total revenues were only about 60% of those of PAA or TWA in the 1948-1949 period and were essentially stagnant whereas those of TWA showed significant gains. As to competition AOA points out that it was faced with direct competition by PAA for 80% of its traffic, whereas TWA had direct American flag competition for only 10% of its traffic. AOA submits that a proper evaluation of such factors supports the reasonableness of its 1949 selling expense ratio and requires reversal of Bureau Counsel's proposed disallowance.

The issue presented is essentially (1) whether the level

of selling expense is substantially within the control of management and (2) if so, is the proposed 19.5% (20.0% for TWA) ceiling reasonable for the carriers here concerned.

On the basis of the evidence of record it must be found that the level of the selling expense ratio is very substantially within the control of management. Selling expense embraces in essence a carrier's costs for selling and ticketing a passenger. Each operating station requires, of course, certain minimum expenditures for this purpose—ticket agents, reservations employees, personnel for processing passengers on the ground, office and counter space, communications facilities,

13101

utilities, local sales and publicity personnel and advertising expenditures. Certain portions of selling expense—non-local advertising and publicity, and expenses related to schedules and tariffs—are normally centered in the carrier's main office. It is apparent, however, that there is great latitude for variation of the amount so expended, over and above what might be considered a minimum, in the location of ticket offices, establishment of "off-line" ticket offices, in the number of sales or traffic representatives employed and in amounts devoted to advertising space and publicity efforts.

Bureau Counsel and the carrier parties have generally agreed that density of traffic is a significant comparative factor in evaluating the relative reasonableness of the selling expense ratios of carriers. Bureau Counsel has relied principally on the figure of revenue ton-miles per route mile per day as an index of density. Since the essential functions giving rise to selling expenses attach with the establishment of each traffic station it is believed that a more appropriate density index is the revenue ton-

miles per station. In appendix B there has been plotted for each domestic trunkline air carrier for the 12 months ended June 30, 1951, the selling expense ratio against the density in terms of revenue ton-miles per station. An approximate trend line has been drawn, indicating, as would reasonably be expected, that the selling expense ratio tends to decline as traffic density increases. A second plot shows the change of the relationship of similar points for each of the carriers here concerned and each of the big four domestic carriers for the years 1947-1951. Apart from the general trend noted, the plots have their major significance in the wide variation of selling expense ratio as between carriers in comparable ranges of density. Possible modifications of the density index for varying yields and average length of haul were tested and found to result in no net improvement in conformity of the individual carrier's points with the trend line. Of particular significance is the fact that each of the big four carriers in 1948 experienced a reduction of density from the prior year, yet each at the same time reduced its selling expense ratio, and further, that the ratio continued to decline in subsequent years as density increased. But the principal conclusion which appears from all such data is that management determination rather than any inherent density factor controls to a substantial degree the selling expense ratio.

Additional matters relating to the selling expense ratio —density plot should be noted. To the extent that there may be a "normal trend" of decreasing selling expense ratio with increasing density it would not be proper to make a direct comparison of the ratios of Panagra, Braniff (international), and C. & S. (international) with the transatlantic carriers here concerned because the former carriers had a much lower traffic density, roughly one-half that of the transatlantic carriers, during the period in

question. With respect to the contention of the Post Office Department for use of the 19.0% selling expense ratio adopted in the PAA-LAD rate case it is noted that the LAD traffic density for fiscal year 1951 was 2,169,000 revenue ton-miles per station. This is substantially above the AOA density of 1,557,000 in 1949, and above

13102

PAA's 1949-1952 level of about 1.8 million. The trend line indicates a reasonable basis for the 0.5% higher selling expense ratio because of such difference in traffic density.

In approaching the matter of the reasonable level of the selling expense ratio Bureau Counsel and the parties have directed their major attention to comparisons between international carriers. But it is believed that a better orientation of the question is obtained by noting certain basic comparisons as between the three transatlantic cariers and the big four domestic carriers, as follows, from 1950 reported data:

	Rev. T-M per-station (000)	Ave. Psgr. Yield (¢ per mile)	Ave. Psgr. Haul (miles)	Rev. Per Psgr.	Psgr. per station per day
PAA	1,672	7.94	1,877	149.03	16.6
TWA	2,143	8.09	2,715	219.64	15.2
AOA	1,829	8.03	1,513	121.49	21.1
AA	3,380	5.58	500	27.90	145.7
EAL	1,878	5.63	466	26.24	93.6
TWA	2,752	5.50	648	35.64	87.4
UAL	2,640	5.52	573	31.63	96.4

In terms of traffic generated per station it is noted that the transatlantic carriers are fairly comparable to, but somewhat lower on average, than the big four. However, when the difference in average passenger yield is taken into account, a minimum of 41% greater for the transat-

lantic carriers, it appears that the resultant revenues per station are very comparable. This is significant because the selling expense ratio is expressed in terms of revenue. Thus, at the same selling expense ratio, it is indicated that TWA (int'l.) could spend more for "selling" per station than could TWA (dom.). The figures for average passenger haul and revenue per passenger indicate the comparatively long haul nature of the international travel, which, together with the differences in yield, is pointed up by the final comparison of passengers per station per day. Again comparing TWA (int'l.) and TWA (dom.), it is seen that at the same selling expense ratio the average domestic station would have to "sell" almost six passengers at the same cost as one for the international station. Applying the actual selling expense ratios for that year it appears that the domestic division of TWA "sold" about 8 passengers for the cost of one "sold" by the international division. The comparison for PAA is not substantially different.

13103

This comparison presents a picture that is somewhat shocking, but it requires certain qualification. While there is little direct evidence on which to compare the relative cost of facilities necessary to the selling function in domestic versus international operations it would logically appear that these would be higher *per station* for international. The international routes serve principally the capitals of foreign countries and it would be expected that rent and utility charges for suitable offices in such points would be higher than for the average of the domestic stations. Leased wires for communications and reservations, because of the greater distances, would also be expected to cost more per station. Language differences would increase the cost of preparation of schedules and promotional material. The cost of advertising space does

not vary with the degree of response and would logically cost more in the foreign capitals than in the average domestic point. To this extent there appears to be some justification for a higher selling expense ratio for the transatlantic carriers than for the big four. Unfortunately, no party endeavored to supply a quantitative measure of the difference represented by such items. TWA did present evidence to show a substantial increase in the cost of newspaper and magazine advertising space in the United States in recent years, and pointed to salary increases for traffic and sales personnel. But if such factors were controlling it would show up in the experience of the big four.

While there may be found general support for higher selling expense ratios for the international carriers on the basis of costs of space, utilities, communications, translation, and advertising space, there still is a substantial part of selling expense which is attributable to employees. There appears no reason why this salary portion of selling expense should be higher for the international carriers here concerned than for the big four. A limited analysis of 1950 reported data indicates that it is lower per station for the transatlantic carriers. In the traffic and sales account the largest number of employees fall in account No. 6432—Ticket Agents and Reservations Personnel. For such employees the transatlantic carriers paid lower average salaries than the big four, and employed a lesser number per station.[43] The lower number of such employees per

[43] Ticket Agents and Reservations Personnel—1950.

	International			*Domestic*			
	PAA	TWA	AOA	AA	EAL	TWA	UAL
Ave. No.	377	194	88	1131	1167	816	1160
No. per Station	11.9	8.7	5.6	17.3	15.1	16.6	16.6
Ave. Salary	2,520	1,380	1,590	3,180	2,760	3,630	3,210

international station still results in a substantially greater number per passenger "sold" than for the big four.

The foregoing cannot be found to justify the high level of selling expense ratios of the transatlantic carriers when comparison is made with the big four. Bureau Counsel has proposed a 19.5% cut-off point, about 50% greater than recent experience of the big four. With respect to a matter of this nature there must, of course, be a zone of reasonableness within which management can act. For the transatlantic carriers it appears that the level experienced by the big four would approximate the bottom of that zone. A 50% spread between the bottom and top provides a generous latitude for the management of these international carriers. The experience of Pan American and Northwest in their Pacific operations substantially confirms this conclusion. As of 1949 the selling expense ratios of these carriers were 19.4% and 17.6%, respectively. 1950 saw the start of the Korean conflict and the selling expense ratios of both carriers dropped substantially, to 17.6% for PAA and to 15.5% for Northwest. The ratio dropped further for PAA in 1951, to 15.2%. then rose to 16.5% in 1952. Northwest's went to 17.8% in 1951 and dropped to 16.2% in 1952. All carriers have objected to comparative use of these ratios for the years 1950-1952 on the basis that the traffic demand over these Pacific routes was so great in this period that there was no need for special "selling" effort. The validity of the objection for purposes of setting the ceiling can be recognized, but the rapid drop in selling expense ratio of these carriers under the circumstances to almost 15% confirms the existence of substantial latitude for management action.[44]

44 The density of these Pacific operations for this period was generally in the range of that of the transatlantic carriers.

The experience of these Pacific carriers, and also the experience of the transatlantic carriers serves to emphasize that there is a relationship between selling expense ratio, load factor, and capacity. At a given capacity, realization of a high load factor permits reduction of "selling" expense. The years 1946-1947 were in this category for the transatlantic carriers, similar to the years subsequent to the Korean conflict for the Pacific carriers. The year 1949, in which AOA incurred its greatest selling expense ratio, was also the year it realized its lowest passenger load factor. For AOA the year 1948 showed an increase of 2.5% in revenue passenger miles over 1947. In 1949 AOA operated 6.3% more seat miles than in 1948. Obviously it had to realize a greater traffic growth rate in 1949 than it had in 1948 to maintain a reasonable load factor. In an effort to achieve that goal it increased its "selling" expense. To the extent that it thereby maintained a load factor that has been deemed adequate to justify operation of the capacity offered, it was successful. But it does not follow that the end justifies the means.

In April of 1949, the Board issued a Statement of Tentative Findings and Conclusions proposing final mail rates for AOA for the years 1946-1948.[45] That statement indicated that the Board had planned to also issue at that time a proposed future rate, but had decided to defer such action because of the carrier's forecast and trends indicating and increasing

dependence upon subsidy. There followed rather strong language warning that the trends must be halted and that uneconomic expansion of service would not be underwritten with subsidy mail pay. In the light of such clear warning AOA's increased selling expense, to the extent that it

45 Order No. E-2731, adopted April 19, 1949.

exceeded a 19.5% ratio in 1949, should not be recognized for mail rate purposes.

AOA's contention that a two-year average should be employed must be rejected. The evidence establishes that the carriers budget selling expense on an annual basis, and revise such budgets during the year as management may deem it advisable. The fact that certain expenditures may be within the zone of reasonableness for certain years does not justify an averaging process to escape the consequence of uneconomic action in another. The other factors advanced by AOA as justifying a favorable allowance, size, rate of growth, and yield, cannot be found to have measurable significance. Traffic density of AOA was comparable to the other carriers and relative size appears to have no controlling significance with respect to selling expense level. Growth is, of course, properly to be anticipated and provided for by management with reasonable expenditures made toward assuring further development. But it is also management's responsibility to keep abreast of traffic developments and variations from forecasts and to take appropriate action to keep expenditures at reasonable levels.

If it were established that the lower yields of AOA resulted from factors beyond its control, such as necessarily longer mileage between competitive points directly served, then adjustment for comparative yields would be made. But the converse is true. AOA had authority to serve such points by routings similar to its competitors. To the extent that it operated by other routings, promoted reduced rate traffic, or entered into interline arrangements which required fare absorption to meet fares by more direct routings, these are matters within the control of management and presumably gave other benefits which were believed to compensate for the reduced yield.

On the basis of the foregoing it is found that amounts

expended by AOA in the year 1949 for Traffic and Sales and Advertising and Publicity in excess of 19.5% of transport revenues were above a reasonable level under economical and efficient management and are not proper for recognition under section 406 of the Act.

Deutschmark Reserve

By Order No. E-2731, April 19, 1949, the Board set up a reserve of $310,000 to cover possible loss on conversion or other disposition of an accumulation of deutschmarks built up by AOA in 1948 during the Berlin blockade and for which there then existed no official means of conversion to dollars. The order provided for a special accounting by AOA to the Post Office Department with reference to this reserve fund and for repayment of amounts not required to cover the loss for which provision was made.

13106

It is agreed that AOA has repaid $131,391 of this reserve to the Post Office. The Post Office acknowledges that it has further withheld payment to AOA of $120,947 to apply against reserve repayments still owing by AOA. The Post Office takes the position that there were no deutschmark losses properly chargeable against the reserve and requests a ruling that the balance of the $310,000 or $57,662 is still to be repaid by AOA. AOA contends that it had losses on conversion or other disposition of this reserve in the amount of $62,839 and hence that such losses, repayments, and Post Office mail pay withheld, more than account for the $310,000.

The issue presented hinges upon the intent of Order No. E-2731. The Post Office Department's position is that deutschmark disbursements made by AOA on and after January 1, 1949, must all be charged to reduce the deutsch-

mark accumulation for which the reserve was provided. On that basis the Post Office submits that the entire accumulation was dissipated without loss[46] prior to September, 1949, AOA, on the other hand, submits that the order in question did not require a first-in-first out accounting for the accumulated deutschmarks and that it still had a substantial portion of the accumulation on hand as of September 19, 1949, on which date it suffered a loss of $62,806 resulting from devaluation of the deutschmark.

A review of Order E-2731 leads to the conclusion that the position of AOA must be sustained. The language appearing therein at pages 24, 25, establishes that from the fall of 1948 forward AOA arranged with the occupation authorities to limit deutschmark sales so that they would be balanced by local deutschmark expenses. This would arrest the growth of the deutschmark accumulation. The order further notes that ". . . further reductions in deutschmark sales which would have been necessary to reduce the balance were not made in view of the request of the occupation authorities in Germany". The reserve which was provided allowed for a 66⅔% loss on conversion, which was the prevailing unofficial quotation. Official conversion was not then possible. At page 38 of Order No. E-2731 AOA was directed not to make any additional reserve provisions for deutschmark losses. In the light of such language it is concluded that the Board approved an AOA operation in Germany which maintained a balance between deutschmark sales and local disbursements and did not require the carrier to reduce its accumulation of deutschmarks by priority of expenditure over subsequent deutschmark sales receipts. It accordingly is found that AOA has properly repaid or accounted for $194,230 of the deutschmark reserve and that amounts withheld by the Post Office De-

46 A conversion loss of $33 in June, 1949, was first claimed by AOA at the hearing. It is not understood that the Post Office disputes this amount because of AOA's failure to report it as required by E-2731.

partment under the temporary rate order exceed the balance due from AOA by $5,177.

Federal Income Taxes:

As of the close of hearing there was dispute as to whether AOA's liability for payment of Federal income taxes on any additional mail pay awarded as a result of this proceeding would be taxable at the rate in

13107

effect for the current year or at the rates which were in effect during the years to which the adjusted final mail pay would be attributable. A subsequent ruling of the Treasury Department[47] has established that the tax rate will be the rate in effect in the year during which payment is made. Tax allowance will accordingly be made at the current rate of 52%

• • • •

Rate of Return:

AOA's mail rate relates only to a "past" period for which Board precedent would allow a 7% return on investment. AOA has reserved the right to contest the adequacy of that rate of return on the basis of evidence and argument of the other carrier parties. On the basis of the findings made *infra* with respect to rate of return it is concluded that the fair and reasonable rate of return on AOA's used and useful investment for the period under review should be maintained at 7%

• • • •

47 Revenue Ruling 169, Internal Revenue Bulletin, August 31, 1953, No. 18.

TWA—Past Period:

Under temporary rate orders in effect during the review period TWA received mail pay totaling $47,271,000. Bureau Counsel's recommended final mail pay for this period is $48,097,000, which indicates a balance due TWA of $825,000. TWA takes issue with Bureau Counsel on treatment of revenue and expense items representing a total of $8,615,000 of breakeven need, contends for recognition of a higher investment, and urges that the rate of return on investment be increased to 13% for past as well as for future mail rate periods.

• • • •

All-Cargo Services:

All cargo flights with DC-4 aircraft were operated by TWA and PAA in the years 1947-1950, and in 1952, with frequency varying from one to three weekly round trips.[52] Bureau Counsel contends that TWA's all-cargo service incurred a loss of not less than $282,115 during the past period and that Board policy properly denies mail compensation for such losses. TWA submits that proper cost allocations indicated that its all-cargo operations yielded a net profit rather than a loss, and in any event were a needed service of minimum frequency which are proper for recognition in computing its need mail pay. Seaboard & Western Airlines, Inc. (Seaboard), contends that all-cargo operations should not be underwritten with mail pay and that the loss attributed thereto by Bureau Counsel is substantially understated.

52 1947-1950, frequency for TWA was one weekly round trip, except for a two-week period when a second trip was added. PAA started with one weekly round trip in May, 1947, increased to two in December, 1948, increased to three in November, 1949, reduced to two in April, 1950, and eliminated these in June, 1950.

In the *Air Freight Case*[53] in which the Board certificated new property-only carriers over extensive domestic routes, the Board indicated that "Facts of record lend credence to the assertion of the applicants that air freight can be developed without subsidy from the Government in the form of mail payments. Certainly we believe it to be very much in the public interest to test the possibilities of reaching this goal through concentration of the efforts of the applicants on the carriage of property only."[54] In line with this statement the Board in the *Big Four Mail Rate Case* of 1951 concluded that it would not be in the interest of the developmental purposes of the Act to cover losses resulting from all-cargo service with mail pay.[55] The recent decision with respect to PAA's Latin American Mail Rates affirms the application of this same conclusion to that international service.

Both TWA and PAA cite 1948 decisions of the Board in the Mail Rate Cases of Braniff[56] and Delta[57] as establishing that experimental all-cargo services flown on minimum schedule frequency would be given mail pay support. Bureau Counsel submits that these decisions were clearly limited to such short-haul markets as were there served.

In the language of section 406 of the Act the issue here presented is whether the all-cargo services operated were, in the legal sense, "used and useful" in rendering the certificated service. Bureau Counsel's position is that they were not "used and useful" to the extent that they

---

53 *Air Freight Case*, 10 C.A.B. 572 (1949).

54 Ibid. p. 591.

55 Order No. E-5560, July 31, 1951, p. 15; made final by Order No. E-5715, September 19, 1951.

56 *Braniff Airways, Inc., Mail Rates*, 9 C.A.B. 607 (1948).

57 *Delta Air Lines, Inc., Mail Rates*, 9 C.A.B. 645 (1948).

failed to earn revenues adequate to cover the added costs at a revenue load factor of about 35%. Some slightly higher load factor would have been needed to also cover the return element. Thus, in effect, the proposed disallowance is a capacity disallowance for all cargo space which failed to realize revenue load factors of approximately 40%. Viewed in this light the question is similar to all prior cases dealing with used and useful capacity and it is clear that the Board has the power in administering the subsidy provisions of the Act to adopt reasonable standards of performance as a measure of proper efficiency. On the basis of all considerations it is concluded that the position of Bureau Counsel applies such reasonable standards and should be adopted for the review period, except for the early post-war period, up through April, 1949, for which period experimental all-cargo operations not exceeding one round trip weekly should be recognized.

As the Board noted in the *Air Freight Case, supra,* the commercial movement of freight by air was a development of the postwar period. In that period many air carriers, certificated and non-certificated initiated "all-cargo" services. Because almost all certificated carriers were on temporary mail rates for several years the final

13109

mail rate decisions in the *Braniff* and *Delta* cases (1948) set forth the earliest Board pronouncements respecting recognition of such experimental services for mail rate purposes. Though limited, the treatment therein was favorable to the experiment and the carriers. As indicative of the temper of the times it is believed significant that in November, 1948, the then head of the Board's rate staff indicated in a letter to TWA that in a future mail rate then in process of negotiation the staff would propose recognition of one all-cargo schedule per week. It was not

until April 19, 1949, in issuing a proposed PAA transatlantic mail rate for 1946-1948, that the Board set forth its present policy, since reflected and amplified in the *Big Four* case and others. It was also in April, 1949, that the Board issued its tentative decision in the *Air Freight Case*, which was made final without substantial modification in July of that year. Thus, beginning with May, 1949, it is concluded that the carriers herein had notice that the Board would not underwrite all-cargo operations with subsidy. The reasons underlying that determination are adequately set forth in the related decisions and no party has presented argument that would merit a different conclusion with respect to this later part of the review period.

The *Delta* and *Braniff* decisions approved experimental all-cargo flights on what was termed a minimum frequency basis, which in those instances amounted to daily flights, 5 days a week. Obviously, a minimum frequency must be related to competitive transit time and an approximate comparison of domestic rail versus transatlantic water transportation would indicate that a reasonable competitive frequency for transatlantic air service would be about one flight weekly each way. To the extent that higher frequencies were added in the earlier experimental period they were not justified by experienced load factors and should not be recognized. But in the light of the evidence of record it is concluded that all-cargo operations of TWA and PAA not in excess of one weekly round trip constituted a reasonable experiment in such service for the period up to May, 1949.

In endeavoring to ascertain the net loss incurred as a result of all-cargo operations subsequent to April, 1949, resort must be made to cost allocations. There are substantial differences between the parties as to the proper allocations to be made. Bureau Counsel has estimated the costs of such an operation on an added-cost basis; Sea-

board contends that such an approach is improper and that the costs should be on a fully-allocated basis.

Seaboard's interest in the all-cargo aspects of the case stems from its status as an irregular air carrier currently engaging in transatlantic carriage of cargo and its pending application[58] for certificate authority to conduct scheduled cargo operations across the North Atlantic to London, European points and the Middle East. It seeks therein no authorization to carry mail and accordingly urges

13110

herein that the development of the cargo marked on a competitive basis between certificated carriers with mail authorization and other carriers without such authority requires that the former be denied mail subsidy on a fully allocated cost basis with respect to their all-cargo operations. Seaboard cites several transportation studies as establishing that the added-cost approach is unsound for pricing a new transportation service since it will inevitably lead to a loss operation when the service grows in volume beyond the by-product stage. There is no doubt as to the validity of this assertion and the Board has indicated agreement by its conclusion that the costs of the non-mail cargo carriers are the most usable guide to the determination of reasonable air freight rates.[59] Seaboard further submits that since the Board lacks power to fix international rates for commercial traffic it must insure against the creation by a subsidized carrier of an uneconomic freight rate structure by assuring that none of the "full costs" of the all-cargo service are supported by subsidy in its mail rate case. Subject to a definition of what Seaboard's "full costs" would cover, its position can be gen-

---

58 Docket No. 3041, et al., *Transatlantic Cargo Case*, hearing closed June 30, 1953.

59 *Air Freight Rate Investigation*, 9 C.A.B. 340, 348 (1948).

erally recognized as valid. Before considering the cost approaches available, however, it should be noted that Seaboard does not suggest that the present tariff rates for transatlantic air freight are below a reasonable level. This is of some significance for it must be assumed, on the basis of other Board orders relating to promotional fares, (or seating densities) that appropriate adjustment would be proposed by Bureau Counsel or other parties if such rates appeared to be unreasonably low.[60]

The major conflict of position as to proper "costing" of the all-cargo service relates to the indirect costs. Typical of these are the "ground operations" account items. In this category Bureau Counsel would charge the all-cargo operation only with the items of cargo handlers, cargo ground space, landing fees and cargo insurance. Seaboard submits that other items chargeable to this group of accounts, such as in-flight communications, office rental, stationery and supplies, telephone and telegraph, administrative flight personnel and training personnel should also be shared by the all-cargo flights and proposes that available ton-miles is a proper basis for allocation. Reduced to its simplest terms the question is essentially whether personnel and equipment serving, say, 38 weekly flights should, upon adding two weekly all-cargo flights, have one-twentieth (5%) of their cost charged against the all-cargo service, even though such indirect costs are not measurably increased by the added flights. Having in mind that we are here concerned

13111

with a determination of the carriers' need for mail pay the answer appears to follow from a consideration of other situations in which Board determinations are well estab-

60 Order No. E-2731, April 19, 1949, American Overseas Airlines, Inc., Statement of Tentative Findings and Conclusions; *Pan American World Airways, Inc., Latin American Mail Rates, Supra.*

lished. First, it is clear that had the two added flights been a useful expansion of regular combination service then the need that the Board would underwrite would embrace only the actual resulting added expenses. There would be no allocation to determine a theoretical need for a 5% increase in these accounts. The second situation is equally clear. Had the two added flights been found to be an uneconomic expansion of regular combination service, then the computation of the amounts to be disallowed would also embrace only the actual resulting costs added by operation of these flights. In the light of such precedents there would appear no sound basis for a different costing approach for assessing a carrier's need attributable to the all-cargo flights in question. Seaboard's requested "full cost" allocations would have the Board set aside for all-cargo operations, the actual economies which are realized by a "persons, property and mail" carrier as the scale of its operation expands. Since all Board mail rate actions have consistently taken the benefit of such economies to reduce mail pay need disbursements, and since such operations are in the discharge of the carrier's certificated responsibilities, to the extent that they meet a reasonable standard of use, the "full cost" allocation for this service is not justified.

It can be recognized that this decision means that an all-cargo service operated as an adjunct to a passenger and mail service should yield a greater profit (or be able to operate at a lesser load factor) than a non-mail all-cargo operation of comparable magnitude. But it does not follow that the non-mail all-cargo operation will thereby be made unprofitable, and applicants for such authority have uniformly stressed the potential growth of the air freight market which, when realized, should effectively eliminate competitive advantages attributable to the scale

of operations. Again, it should not be overlooked that the developmental purposes of the Act, considered with respect to air freight, are served by many combination flights of the persons, property and mail carriers, and perhaps by low load factor all-cargo flights of these carriers, to points that would not presently produce traffic adequate to support service by a non-mail cargo-only carrier. The contribution to the growth of total air freight traffic produced by such operations will in future years benefit all carriers serving the market.

Specific differences between Bureau Counsel and the carriers as to the proper amounts to be assigned in different accounts to arrive at a reasonable "added-cost" of the all-cargo operation have been considered. Resolution of such differences is not necessary to the determination of this issue as it relates to TWA, but will be considered later in connection with the all-cargo issue for PAA.

Apart from the issues relating to proper costs, or expenses, to be attributed to the all-cargo service, there are equally significant issues with respect to the question of the revenues which should be

13112

credited for that service. The sub-classification of the "cargo" actually carried on these flights includes air-freight, excess baggage, U. S. mail (including diplomatic mail, or pouches), foreign mail, and company material (comat). All parties agree that the revenues from air freight and excess baggage moving on all-cargo flights should be credited in full. All agree that some revenue credit should be computed for the comat carried, but there is dispute as to the amount of the credit. Major disputes relate to revenue credits for U. S. mail and foreign mail.

With respect to U. S. mail TWA contends that the all-cargo flights should be credited for the actual ton-miles

carried at rates not lower than 85 cents a ton-mile which the Board has indicated in its report "Administrative Separation of Subsidy from Total Mail Payments" is the proper service rate for transatlantic carriers. If such credit is made TWA submits that its all-cargo service will show a profit. Bureau Counsel, on the other hand, takes the position that the all-cargo flights merely transported mail that would have been adequately served on other flights if the all-cargo schedule had not been flown; that the carrier still requires mail pay subsidy, and that there is no basis for computing a credit at a "service rate", or any other rate when the purpose of this proceeding is to determine its subsidy need. The position of Bureau Counsel must be accepted. To hold otherwise would in effect amount to a double compensation for the carriage of U. S. mail, once on the all-cargo flight and again on the carrier's other flights where it would have moved but for the existence of the all-cargo schedule. As a refinement of the foregoing position Bureau Counsel conceded that to the extent the carriers could demonstrate that the constructive shifting of the U. S. mail carrier on all-cargo flights to the next departing regular flights would have resulted in a loss by the carrier of other traffic on board then the all-cargo flight could claim revenue equal to that which derived from such constructively lost traffic. TWA analyzed its flight load factors for this purpose and submits that the credit to be allowed totals $654,000 for the period 1947-1950. Bureau Counsel proposes to recognize only two-thirds of this amount. The disagreement is principally a matter of judgment. TWA's derivation of the $654,000 figure assumed that resultant overloads would displace passengers, a high yield traffic, and that all which were so displaced would be lost. It further noted that about two-thirds of passenger sales were for round-trip

travel and so computed the revenue loss for displaced passengers on such basis. Bureau Counsel submits several reasons for modifying this approach, suggesting (1) that the Post Office would probably have revised its required mail allocations to avoid the excessive burden on the next combination flight, (2) the carrier could have displaced other, lower yield, non-round trip traffic, such as comat and air freight before passengers, and (3) complete loss of the constructively displaced traffic is unrealistic; a substantial amount could have been booked on other flights. Each of the modifying contentions of Bureau Counsel is found to have merit and the judgment recognition of two-thirds of TWA's claim is determined to be a fair and reasonable credit for this item.

13113

With respect to foreign mail, Bureau Counsel proposes to recognize as all-cargo flight revenue only so much as would have been constructively lost to another carrier had the all-cargo flight not operated. The TWA foreign mail credit so computed is $181,000. But TWA contends that foreign mail should be considered the same as air freight with full credit for the actual revenue derived from the foreign mail which was carried on the all-cargo flights. That revenue, for the 1947-1950 period was $811,000 and a full credit would indicate that TWA's all-cargo service meets the standard of profitability. Bureau Counsel's proposed treatment of this category of revenue is essentially the same as for U. S. mail. But the reasons which are found to support the validity of such approach for U. S. mail do not exist with respect to foreign mail. We are not here concerned with setting a rate for the carriage of foreign mail. That rate is otherwise set through processes of the Universal Postal Union. It further appears

from evidence of record that the tender of foreign mail to a U. S. air carrier is substantially influenced by schedule availability and timing, the same factors which attract or lose normal commercial traffic for a given flight. The question is therefore how far we should inquire, if at all, as to how much of such traffic which was served by the all-cargo flight could have been retained by and accommodated on other flights of the same carrier? Bureau Counsel has proposed no such inquiry with respect to the air freight and excess baggage which moved on the all-cargo flights in question. In the absence of a showing that the attraction of such traffic to the all-cargo flights constituted a diversion from the carrier's other flights to such an extent that the latter's revenue loads were thereby brought below a reasonable level it is concluded that there is no sound basis for such inquiry. An appropriate analogy may clarify this conclusion if we assume that a carrier, during a period under review, increased from 19 to 20 the number of weekly combination flights serving a given segment; that the established "used and useful" test for this segment was a 60% commercial traffic load factor, and that the load factors for the 20 flights met or exceeded this standard. Bureau Counsel's approach here is the equivalent of analyzing the 20th flight, finding that one-half of its traffic could have been retained by the carrier and accommodated on the other 19 flights, deriving a constructive 30% load factor for the 20th flight and recommending its disallowance for failure to meet the established standard. Such a method has never been employed and the fact that the 20th flight may be an all-cargo flight rather than another combination flight does not justify such an untenable approach. No party has suggested that TWA's other flights operated with average loads falling below a reasonable level.

The conclusion to credit in full the foreign mail revenue

which accrued to the all-cargo flight on the basis of actual volume carried puts the TWA all-cargo flights into a profit status even if all other adjustments proposed by Bureau Counsel were accepted. Such result

13114

requires a reversal of the disallowance proposed by Bureau Counsel and it is unnecessary to consider the further contentions.[61]

Flood Loss:

TWA's maintenance base at Kansas City, Kansas, was flooded in July, 1951, causing loss in the amount of 6 million dollars. Of this total, 4 million dollars was recovered by the carrier through insurance leaving a 2 million dollar uninsured loss. It is agreed that $620,000 represents a proper allocation of this net loss to the international division. Bureau Counsel does not criticize TWA's decision in selecting this location for its maintenance base and agrees that provision should be made for covering the loss. The sole point in dispute is how the loss should be treated for mail pay purposes.

TWA submits that it should be recognized as expense in the year of the flood. Bureau Counsel submits that the carrier should have established a self-insurance reserve to cover the uninsurable potential flood loss. Based upon his analysis of the flood probabilities Bureau Counsel proposes that the reserve should provide for a loss such as was experienced once every thirty years. The annual accrual to the self-insurance reserve would accordingly be

61 The difference between the foreign mail credit of $181,000 proposed by Bureau Counsel and the full revenue of $811,000 recognized ($630,000) is more than adequate to offset the $282,115 breakeven need estimated by Bureau Counsel and cover a return on the investment devoted to the all-cargo service.

$66,667, of which $18,800 would relate to the international division. • • •

• • • •

Termination Indemnity Reserve:

Certain foreign countries in which TWA employs foreign nationals have laws which require the employer to pay termination or severance compensation to such employees.[63] The laws of Italy were summarized as illustrative, which provide a basic requirement of one month's pay for each year of service upon termination. This amount is payable upon any termination except a discharge for cause (larceny, etc.) or, in the case of hourly workers, upon voluntary resignation. It is payable on death to the employee's estate. The full termination compensation is payable after ten years of service, 75% between five and ten years and 50% between 90 days and five years.

Beginning in 1950, TWA set up a reserve to cover its estimated termination indemnity liability. The balance in the reserve account, accruals less payments made, as of December 31, 1951, was $197,924. Bureau Counsel has estimated that it would be about $300,000 a year later, the end of the review period herein. Bureau Counsel proposes that this reserve balance be disallowed as an expense of the past

13115

period for the reasons that the liability is contingent and hence indefinite as to occurrence and amount. TWA contends that its reserve account for termination indemnity liability is necessary to reflect in each year's charges the expense of doing business in that year. The accounting

63 The countries are Italy, Greece, Egypt, Portugal, Israel, Spain, Iraq and Lebanon.

propriety of the reserve has been affirmed by TWA's outside auditors who are of the opinion that "failure to record such liabilities as they accrue would not be in accordance with sound accounting and would require a disclosure and qualification in our report." TWA submits that Bureau Counsel's position on this issue is inconsistent with that taken with respect to TWA's flood loss.

Bureau Counsel replies that the question presented is not one of proper, conservative, accounting treatment for these contingent expenses, but rather one of proper costing for rate making purposes, i.e., is it proper for mail rate purposes to underwrite annual charges to this reserve in excess of actual costs experienced? The question must be answered in the affirmative.

Testimony of record indicates that TWA has experienced a very low turnover rate among its foreign national employees since the start of its international operations in 1946. In 1951, just five years later, it had to increase the reserve substantially to reflect the 75% rather than 50%, liability for many such employees who had served this entire period and were continuing as TWA employees. Clearly, the past period reflects no cash termination expense for this substantial group of employees. • • •

• • • •

General and Administrative Expense:

In the first three years of its international operations TWA's expenses recorded in the General and Administrative accounts were at a level substantially higher than those of PAA and AOA. Bureau Counsel contends that a substantial part of such excess cost results from inefficient and uneconomic management and proposes the disallowance of $1,428,000 of reported expense for the three

years.[65] Bureau Counsel's approach to this disallowance is based upon the ratio of General and Administrative expense to all other cash operating expense. Numerous adjustments of TWA's reported data were allowed by Bureau Counsel before arriving at the recommended result. The comparative ratios (per cent) for TWA, PAA and AOA are as follows:[66]

13116

	1946	1947	1948
TWA — Reported	25.82	19.47	17.79
— Adjusted	20.77	15.20	12.88
— Recognized	16.00	14.16	11.70
PAA	13.36	11.26	9.47
AOA	13.23	14.16	11.70

The level proposed for recognition for TWA is based upon a 20% increase over the average PAA-AOA level for 1946 and upon the AOA level, which was higher than PAA's, for 1947 and 1948. Bureau Counsel notes that the amount proposed for recognition is $1,070,000 more than it would be at the average PAA-AOA level, and further notes that the issue herein is not related to pre-operating expenses which are being recognized in the amount claimed by TWA—$1,980,000.

TWA contests the proposed disallowance on several grounds: It was the new carrier in the transatlantic service, it extended service faster in this period, it experienced greater foreign language problems, served foreign countries which were most disrupted by war and post-war inflation,

---

65 Breakdown of the total by years is: 1946—$836,000; 1947—$248,000; 1948—$344,000.

66 First year G. & A. ratios for other carriers initiating international services in this post-war period were: Northwest (1946-47), 13.97%; Chicago and Southern (1946-47), 11.85%; Braniff (1949), 13.06%. All of these operations were on a smaller scale than the transatlantic services.

and had to establish offline training, maintenance, and operations bases for its international service. Bureau Counsel recognizes that TWA necessarily incurred greater G. & A. costs than PAA-AOA because of the rapid expansion, language and local law problems of France (TWA's main overseas base) in contrast to Great Britain for PAA-AOA, that political turmoil and economic disruption in France, Italy, Greece and Egypt were more widespread than in the PAA-AOA countries and would call for some higher level of G. & A. expenditures by TWA. But Bureau Counsel submits that other factors were favorable to TWA or not significant and that the recommended differential in favor of TWA is adequate to cover all reasonably incurred G. & A. expenses.

It is clear from the evidence of record that TWA expended comparatively high amounts in the G. & A. category during the initial years in question. Because it was new to international service in 1946, and AOA and PAA were not, TWA submits that a proper consideration of costs should compare years of similar experience, i.e., 1946 for TWA should be compared to 1945 for AOA and PAA, etc. On such a basis TWA's costs for the first three years of international service were in line with those of AOA and PAA on a revenue plane mile or available ton-mile basis. But the argument lacks any substantial merit. TWA operated a substantial volume of transatlantic service with DC-4 aircraft during the war under military contract. Its initial certificated operations in 1946 utilized the same aircraft and added L-49 Constellations as acquired. Much of AOA's and PAA's 1945 certificated operations utilized seaplanes having higher operating costs. These carriers during 1945 discontinued the seaplane operation and initiated DC-4 service requiring substantial

changes of station locations with duplicate facilities for certain periods. These items alone would make the AOA and PAA unit costs in 1945 higher than would be expected in the absence of such change of equipment. TWA was faced with no such problem in 1946. In the 1946-1948 period all three transatlantic carriers operated the same types of equipment and there appears no reason why TWA should be at any comparative disadvantage in the direct operating cost accounts. In fact, if its domestic experience be considered, its volume of operations with these aircraft types materially exceeded that of AOA or PAA and should have contributed to operating efficiency and economy. In 1946 TWA did expand its route to foreign points at a faster rate than AOA or PAA. And this factor is accepted by Bureau Counsel as a substantial reason for allowing TWA a 20% higher G. & A. ratio allowance in this year. But the rates of expansion of all three carriers were comparable in 1947 and 1948.[67] If the 1946 experience of TWA in starting service to new foreign points was of value, then it should have been equipped to effect the 1947-1948 expansion as efficiently as either of the other carriers. Such considerations fail to support TWA's contention that its costs should be generally compared with the prior year's experience of AOA and PAA in the 1946-1948 period.

Unusually severe inflation and political unrest in TWA countries may be accepted *arguendo,* as having increased the cost of doing business at such points in this period, but

---

67 Foreign stations added by the three carriers by years were as follows (exclusive of PAA's South Africa route):

	1946	1947	1948
TWA	13	3	1
PAA	5	5	4
AOA	6	2	—

since the test herein applied is a ratio between G. & A. and other cash costs it does not follow that the ratio would be disturbed. In fact, an analysis of the inflation factor made by Bureau Counsel indicates that a smaller part of TWA's G. & A. expenses were paid in foreign currencies than of its other cash expenses which would indicate that inflation should tend to reduce the G. & A. ratio.

TWA's excessive G. & A. ratio is established not only by comparison of TWA's G. & A. expense ratio with other carriers but also by affirmative evidence of organizational and record keeping changes made in 1947-1948. Following the resignation of the President and Chairman of the Board early in 1947, because of management, disagreement with the Board of Directors, a three-member executive committee proceeded to analyze cost controls, organization, etc. The carrier's outside auditors were asked to examine accounting and reporting requirements necessary to maintain adequate and current information at foreign stations and headquarters. The auditors

13118

report found the existing reporting practices to be "beyond reasonable requirements" and recommended changes which "should considerably simplify your accounting, and, as a consequence, result in a reduction of accounting personnel." The recommended accounting changes were made. In addition, organizational changes made in 1947-1948 eliminated ten separate departments of the international division, merging these functions with the system staff. Separate traffic and accounting staffs for the international division in the United States were also eliminated.

There is difficulty, admittedly, in endeavoring to assess how much of TWA's higher G. & A. expense in these early years was reasonable and how much stemmed from overly elaborate organization, administrative staffing and ac-

counting. In advancing many of its points in support of the higher expense, TWA has only been able to contend that they resulted in increased costs—it does not know how much. On the other hand TWA has assailed the comparative approach used by Bureau Counsel on numerous grounds. Considering all such contentions it is found that the comparative approach is proper and that Bureau Counsel has made reasonable adjustments of reported data to correct for known differences between the carriers compared, with one exception. That exception relates to taxes which are currently reported in the G. & A. accounts. These include payroll taxes, general taxes, franchise taxes, gross receipts, taxes, property taxes, and others which would clearly be at varying levels in the different foreign countries served. For the 1946-1948 period in question it appears that such taxes averaged a higher percentage of TWA's operating expenses than they did for PAA[68] or AOA. Since it appears that TWA's higher tax level was beyond the control of management it is found proper to eliminate the reported taxes for each carrier before making comparison of G. & A. ratios. Such adjustment reduces Bureau Counsel's proposed disallowance by $132,000, from $1,428,000 to $1,296,000.[69] Other adjustments which TWA requests to put the accounts on an equal basis cannot be made. Thus, PAA makes purchases for certain affiliates and receives a "commission" for its effort which it applies to reduce its G. & A. expense. TWA contends that this entry makes an unwarranted reduction of PAA's G. & A. expense ratio. But this would hinge upon whether PAA's "commission" covered more than its G. & A. expense

68 In 1946 PAA reported these taxes on the basis of a different accounting system from that of AOA and TWA, which distributed them in part to accounts other than G. & A.

69 Tax adjustments are computed by the method set forth in App. "C" of TWA's brief. The revised G. & A. disallowance by years is: 1946—$786,000; 1947—$320,000, and 1948—$184,000.

of making such purchases. The record does not establish that this is a fact, or, if so, how much of the "commission" is over and above PAA's actual expenses. In the absence of such evidence no adjustment can be made. The record is similarly incomplete with

respect to adjustments sought by TWA relating to military contract fees and management fees. Lacking information as to how much, if any, part of such fees relates to G. & A. expense, and how much is profit, no adjustment can be made.

Taking another tack with respect to the management fees and military contract fees, TWA submits that even if they are all profit, they represent "other revenue" deriving from the carrier's administrative functions and hence should be offset against any proposed G. & A. disallowance. But the proposal is at odds with substantial precedents clarifying the nature and established treatment of "all other revenue" within the meaning of section 406. It attempts to reduce a required disallowance by misapplication of other revenue which the Act directs be considered in determining the carrier's need.

In a general approach, TWA contends that the Board has afforded more liberal treatment to new international carriers in their inaugural period than Bureau Counsel here proposes for TWA. Specifically TWA refers to the PAA and AOA rates set for the year 1945 which recognized for AOA expenses per ton-mile which were 28.2% higher than those for PAA. But it does not appear that this resulted from "more liberal treatment." At the present time, when flight frequency of the transatlantic carriers averages several round trips daily, it is well to recall that PAA's 1945 frequency was 1.4 round trips per week, and that AOA's

1945 service volume was about 25% that of PAA. The very opinions which TWA cites clearly evidence the Board's conclusion that the high costs therein recognized were related significantly to the limited volume of operations conducted.[70] Again, it would reasonably appear that the return of AOA and PAA to common carrier service in 1945 following wartime contract operations for the military entailed some expenses of the type which have been recognized for TWA as "preoperating expenses." Since these carriers were not inaugurating a new service no segregation and capitalization of such expenses was permitted. Considering all such comparative aspects it cannot be found that TWA is herein being subjected to any more rigid accounting for its inaugural period.

Finally, TWA points to its overall record of low-cost operation in transatlantic service and argues that the early expenditures have paid off—hence they should be recognized. If it could be reasonably found that these high early expenses contributed to the carrier's subsequent low-cost position the contention would be accepted. But in the light of the evidence of early excess of administrative personnel and records and the ensuing reorganization and modification of accounting control and reports such conclusion cannot be reached. In the light of all the evidence it is concluded that the carrier's expenditures in the General and Administrative accounts were in excess of amounts attributable to economical and efficient management by the amount of $1,296,000 for the 1946-1948 period.

---

70 Pan American Airways, Inc., Transatlantic Mail Rates, 8 C.A.B. 267, 272-3; American Overseas Air. Mail Rates, 7 C.A.B. 169, 175-6.

(13120)

13120

Strike:

From October 21 to November 15, 1946, TWA's operations were interrupted by a pilot strike. The carrier and Bureau Counsel have agreed that the strike cost was $506,000; return on investment for the period at 7 percent is $84,000 and depreciation charges were $30,000. • • •

Selling Expense:

As was noted earlier in the section relating to the AOA selling expense issue, Bureau Counsel has urged adoption of a 19.5% selling expense ratio for AOA and PAA, but concedes that a higher allowance, 20.0% should be set for TWA because of the competitive advantage held by its competitors resulting from use of the Boeing B-377 aircraft. TWA's selling expense ratio was 22.0% in 1951 and 22.3% in 1952. Disallowance of the amounts in excess of 20% would eliminate reported expense of $666,567 in 1951 and $927,504 in 1952, a total of $1,594,071.

In the earlier analysis relating to AOA it was concluded that the general position of Bureau Counsel urging adoption of the 19.5% ceiling on selling expense ratio for AOA was proper. The questions now presented are whether that same limit should be applied to TWA, whether the 20% limit is a more proper level, or whether, as TWA contends, its full expenditures should be recognized. • • •

The B-377 as used by AOA and PAA was planned for production immediately following World War II. There is of record a cost analysis made by PAA as of August, 1945, to compare the operating costs of the B-377, the L-49 and the C-54 (DC-4). Significant data contained in that analysis is as follows:

	C-54	*L-49*	*B-377*
Interior Arrangement (Seats)	42	51	78
Cost/Rev. Mile (1500 mile range)	$1.46	$1.61	$2.40
Cost/Rev. Psgr. Mile (65% L.F.)	5.42¢	4.88¢	4.80¢
Initial Cost		$675,000	$1,400,000

It will be noted that the cost per revenue passenger mile was essentially the same for the L-49 and B-377. The slight difference in favor of the B-377 disappears if there be added an allowance for return on investment to compensate for the higher relative investment in the B-377. It is also noted that the seating arrangement upon which this result was reached called for 78 seats in the B-377, or 1.53 times the number established for the L-49.

The L-49's put in service by AOA, PAA and TWA in 1946 had an interior arrangement of 43 passenger seats, two of which had to be reserved for extra crew members on the transatlantic hops, giving 41 seats actually available for sale. The B-377's began service in 1949 for AOA and PAA with an interior arrangement of 75 seats, but 14 of these were on a lower deck which was set aside as a lounge. Again, two seats had to be reserved

for the larger crew on transatlantic hops, giving only 59 seats which were available for sale. In various computations of "standard" capacities used in the proceeding Bureau Counsel has used these figures, 41 for the L-49 and 59 for the B-377, as the standard seating capacities for these aircraft. Assuming that the PAA cost study of August, 1945, correctly forecast the operating cost of the B-377 as 1.5 times that of the L-49 on a per plane mile

basis, it follows that the failure to put on sale 62 seats (1.5 x 41) for the B-377 made it a more expensive airplane to operate per available seat mile than the 41-seat L-49.

Both AOA and PAA have testified that substantial difficulties were experienced in early operations of the B-377 which increased operating costs and reduced utilization below the level which had been anticipated. Yet it reasonably appears that the B-377 did, except for the year 1949, achieve a cost level approximating 1.5 times that of the L-49 per plane mile.[71] With reference to the B-377's 59 seats available for sale, rather than 62, it is noted that the B-377's luxury interior attracted passengers to such extent that it realized a 1949 passenger load factor of 66.9% (based on 59 seats) as compared to TWA's L-49 load factor of 58.5% (41 seats). Thus, even if the position were taken that PAA should have made available for sale 62 seats in the B-377's it would still have realized, in 1949, passenger load factors of 63.7%, substantially higher than those for TWA's Constellations.

* * * *

But this does not answer the question of whether PAA was justified in maintaining the original interior arrangement of the B-377 in the light of subsequent competitive developments. As had been previously noted, TWA placed a new, larger capacity Constellation, the L-749A, in international service in 1950. Actual transatlantic seats avail-

---

71 After making all proposed adjustments of reported data except for one final PAA general cost level disallowance, Bureau Counsel's analysis shows the following direct operating expense (in dollars) per plane mile:

	1948	1949	1950	1951	1952
Constellation—TWA	1.80	1.74			
Constellation—PAA	1.85	1.74	1.72	1.84	2.21
B-377—PAA		3.04	2.51	2.48	2.69
Ratio, B-377 to 1949 Constellation		1.75	1.44	1.43	1.54

able for sale in that aircraft were 45, and its interior arrangement also

13122

included a lounge, all of which were on one deck. In addition it appears that the L-749A was an appreciable improvement over the earlier model Constellations. As compared to the 1949 Constellation cost per plane mile of $1.74, TWA's L-749A costs per plane mile were (after Bureau Counsel's adjustments) $1.48 for 1950, $1.52 for 1951 and $1.64 for 1952. The absolute reduction in TWA's plane mile cost together with the higher number of available seats put that carrier's seat-mile costs substantially below that of PAA's B-377. Bureau Counsel has computed the cost difference resulting from this factor as $6,893,000 for the years 1950-1952. Bureau Counsel does not contend for the disallowance of any part of such higher PAA expense.

There is substantial evidence establishing that the B-377 as operated by AOA and PAA, particularly the "lower lounge" feature, gave it an attractiveness to passengers superior to that of any of the Constellation models. To that extent the B-377 gave to the carriers operating it a sales advantage when competing with carriers operating other types of equipment. It was previously noted that the August, 1945, study of comparative costs made by PAA was based upon 78 seats in the B-377. The Board's statement of February, 1950, proposing rates for each of the three transatlantic carriers for the period on and after January 1, 1949, observed, with respect to the B-377:

> ". . . the Boeing aircraft, with the configuration presently contemplated by AOA and PAA, provides approximately a fifty percent greater seating capacity than the Constellation and, according to the most recent estimates of the carriers and the manufacturer, will be operated at the same or lower seat

mile costs than the Constellation. Moreover, AOA and PAA have indicated that the Boeing can be modified to permit the installation of approximately 100 seats, or better than double the passenger capacity offered by the Constellation. This provides further assurance, with reasonable control of capacity in relation to traffic, for the realization of a cost per revenue unit with the Boeing as low or lower than that of the Constellation."[72]

Whether PAA's retention of the initial interior arrangement of the B-377 in 1950 and later years was an action of economical and efficient management has not been made a specific issue in this case. As regards the issue of TWA's selling expense it is only necessary to observe that PAA made no change in seating density, that the B-377 thereby retained a competitive advantage in the way of passenger attractiveness, that the B-377 could have been modified to a higher seating density interior with a probable diminution or loss of its passenger preference, but which would have resulted in seat mile costs more comparable to the L-749A, and that PAA's claim herein for need mail pay is higher than TWA's, because of PAA's operation of the B-377 aircraft, by an amount substantially greater than the proposed disallowance of TWA's selling expense.

13123

It is clear from the record that the bulk of the traffic across the North Atlantic to Europe and Asia was competitively served by PAA and TWA. While the amount of direct competition was substantially increased following the 1950 decision in the *Route Transfer Case, supra,* there

72 Statement of Tentative Findings and Conclusions accompanying Orders E-3880, 3881, 3882, adopted February 7, 1950, at p. 13.

was still substantial competitive service employing connecting carriers prior to that time. Recognizing the existence of competition between PAA and TWA for traffic it is noted that fares were equalized and the essential areas available to management for attracting additional passengers were (1) more attractive service or (2) greater sales promotion effort. To meet the B-377 advantage held by PAA in the first area TWA might have elected to arrange the L-749A with a lesser number of revenue seats, with a larger lounge, or a more luxurious seating arrangement. Instead it elected to use a more economical seating density and increase its efforts in the second area. • • •

Undercollections:

In accordance with the earlier discussion of the similar issue relating to AOA, it is found that the level of TWA's undercollections was reasonable and should be allowed as reported.

Executive Salaries:

Bureau Counsel proposes to disallow, for mail pay purposes, a total of $49,791 of salaries paid by TWA to its Chairman of the Board and President in the years 1950-1952, representing to international division's share of salaries in excess of $65,000 per year. The question presented is not related to the worth of the individuals to the company or a proper salary level for them. Management is free to reach its own decision in the matter. The sole question, in the view of Bureau Counsel, relates to how much of such salaries should be underwritten by the taxpayer through need mail pay rather than by the stock-

holder. The standard of $65,000 per year is roughly based on the average of the average salary and the highest salary paid the presidents of American, Eastern and United in 1950 and 1951.

Board policy of setting limits to the amount paid in salary to top airline executives which will be underwritten with need mail pay is well established.[73] The ceiling herein proposed is substantially higher than those set in the cited cases, recognizing a substantial difference between the size of the carrier there involved and TWA. On the other hand the basing of the standard on the salaries paid by American, Eastern and United during years when they were operating on service mail rates appears to provide a proper comparative base.

13124

TWA challenges Bureau Counsel's proposal on the grounds (1) that it fails to find that the actual salaries paid were an action of uneconomical or inefficient management, (2) that salaries paid top industry executives of concerns doing a comparable dollar volume of business were higher than those paid by TWA, and (3) that the average salary of all comparable officers was lower for TWA than for PAA.

The first objection is somewhat elusive since the salaries were not set by "management" in the normal usage of that word. They were set by the stockholders through their elected representatives, the directors of the company. To the extent that the stockholders or directors thereby were the "management" within the meaning of section 406 of

---

[73] *Trans-Texas Airways, Mail Rates*, 12 C.A.B. 101 (1950); *Los Angeles Airways, Inc., Mail Rates*, Order E-6054, January 25, 1952; *Reeve Aleutian Airways, Inc., Mail Rates*, Order E-7286, April 8, 1953 made final by Order E-7325, April 23, 1953; *Pacific Northern Airlines, Inc., Mail Rates*, Order E-6434, May 16, 1952.

the Act it can certainly be found that their decision was uneconomic to the extent that it would entail subsidy assistance to cover salaries in excess of the level paid executives having comparable responsibility in the industry. It is only reasonable to assume that the stockholders or directors in taking action to increase salaries above the going rate acted principally upon their confidence in the individuals concerned and an anticipation that the carrier's earnings under such management would be increased by amounts exceeding the salary differentials. In either event the higher salaries should not be recognized for mail rate purposes.

The higher salaries paid by other industries cannot influence the decision here. TWA can pay similar amounts if it sees fit, but not with subsidy. It was not suggested that the other industry average included any amounts paid by the Government as subsidy.

TWA's third contention goes not to the merits of the disallowance proposed for TWA, but instead suggests that a different approach looking to the level of all officers' salaries would indicate a possible disallowance for PAA. Neither TWA nor any other party has proposed that a PAA disallowance based upon such approach be determined as an issue herein. The absence of such issue cannot alter the result as to TWA. It is accordingly determined that salaries paid by TWA to its Chairman of the Board and President in excess of $65,000 per year in the years 1950, 1951, and 1952 should be excluded from expense (international) in determining the carrier's mail pay need.

Executive Aircraft:

During 1946 and 1947 TWA owned a B-17 aircraft which it used for executive travel. TWA concedes that Board precedents call for disallowance of the operating expenses

of this aircraft less a credit for the commercial value of the transportation it provided. It is agreed that the net disallowance which would thereby result is $51,850. The issue herein arises solely with respect to a profit realized upon sale of the aircraft, of which $28,778 was allocated to the international division. TWA submits that this profit should be used to offset in part

13125

the normal disallowance. Bureau Counsel contends that the carrier must stand the entire disallowance of operating expense and that the profit on the sale of the aircraft must be applied to offset the remaining need of the carrier as "all other revenue" within the meaning of section 406. Bureau Counsel has cited several prior Board decisions which it alleges support this position, but, in fact, they only support the point that TWA concedes, that executive aircraft expense in excess of the value of the transportation performed will be disallowed for mail pay purposes. None of the cited cases were concerned with a profitable sale of such an aircraft.

• • • •

Non-Operating Items:

Apart from the question of whether fees earned from government contracts and associated companies should be credited to offset proposed G & A disallowances, discussed *supra,* there remains but one area of disagreement between TWA and Bureau Counsel relative to non-operating items. This relates to interest income received by TWA from investment of portions of its general fund. Bureau Counsel submits that such interest is properly "other income" to be applied to reduce the carrier's need. TWA contends that such interest income should be applied

to reduce non-allowable interest expense to the extent that interest expense arises from debt not reflected in the air carrier investment. The amounts in issue are $60,489 for the years 1946-1951 and $58,000 for the year 1952, a total of $118,489. To clarify the issue TWA presents a simplified example, as follows:

> "Suppose a carrier, with a stockholders' equity of $1,000,000, borrows another $1,000,000 on short term notes at 4 percent interest. Suppose also, that the need for which the money was borrowed does not materialize as rapidly as was anticipated, and the funds are invested in Government bonds at 2 percent. At the end of a year the carrier would have spent $40,000 in interest, and received $20,000 in interest income. Under Bureau Counsel's method, the carrier's 7 percent return on its $1,000,000 investment (the short term debt being excluded) would be $70,000 less the $20,000 interest income, or a net $50,000. The carrier had to pay $40,000, so its net income becomes $10,000, or 1 percent on investment."

The example first errs in reducing the 7% return ($70,000) by $20,000 interest income to arrive at a net return of $50,000. The application of the $20,000 to offset a part of the carrier's need does not affect the recognized investment or the return rate allowed. Hence the $70,000 return is only affected by the $40,000 interest on the short term notes leaving, according to TWA, a net income of $30,000,

13126

or 3% on investment. But the example's most significant error is in the parenthetical phrase "(the short term debt being excluded)". This is in error by approximately 75%.

In the computation of allowable investment for mail rate purposes the principal amounts recognized relate to the equipment assets shown on the left, or asset, side of the balance sheet. But resort is had to both sides of the balance sheet to determine a proper "working capital" allowance. For present purposes it is adequate to consider that the working capital represents the excess of the current assets over the current liabilities.[75] Such excess, up to a total equalling 90 days cash operating expenses, is normally recognized as working capital. TWA did not have working capital on hand up to that limit during the review period so that its entire working capital is being recognized. The value of the 2% Government bonds in TWA's example would be shown on the balance sheet under current assets. The short term notes payable would appear under current liabilities. If the full amount for each were used in computing working capital then they would offset each other. But this is not done. The Government bonds would normally be taken at face value as a current asset, but the short-term (within 1 year) notes payable are normally eliminated to the extent of 75% of the total in computing allowable working capital. The reason for such treatment appears sound. A Government bond can be sold or a note receivable can be discounted to raise ready cash and thus they represent sources available to management for working capital in any 90-day period insofar as their value exceeds that of notes coming due within that 90 days. But it is clear that this normal method for computing working capital would recognize in TWA's example an additional amount of $750,000 as "working capital" investment. Thus the return to TWA at 7% would be $122,500 ($70,000+$52,500), or a return on equity investment of 8.25% after payment of the $40,000 interest

[75] Certain other items on both sides of the balance sheet are also considered, but they are not material here.

on the short term notes. In the light of these corrections to TWA's example it is clear that the carrier is amply, if not excessively, compensated for its short term debt holdings and the amount of interest in issue should be treated as all other revenue and used to offset the carrier's need.

• • • •

Investments

There is no disagreement between TWA and Bureau Counsel as to proper amounts to be recognized for the carrier's fixed investment. It is further noted, with approval, that Bureau Counsel has on brief receded from an

13127

earlier position which proposed to disallow capitalized interest on part of a commitment fee paid by TWA in connection with the purchase of its L-749A aircraft. Bureau Counsel previously proposed to allow capitalization of the 1% commitment fee for only 6 months prior to delivery of the aircraft, but on brief has agreed that the entire amount of $134,510 should be recognized since it was less for the entire period concerned than would have been required had TWA borrowed funds for a down payment at 3% interest for a 6-months' period.

There remains one area of disagreement relating to the "working capital" part of the carrier's investment. The issue is whether TWA's international mail pay should be credited solely to the working capital of the international division or whether it should be split between divisions in proportion to their relative cash operating expenses. TWA contends for the former; Bureau Counsel for the latter.

Basic to the issue is the fact that TWA, while maintaining property records, operating data and profit and

loss statements by divisions (domestic and international), has never seen fit to establish on its books a segregation between divisions for balance sheet purposes. The only balance sheets filed by the carrier cover the company as a unit—the "system" operations. It follows that in considering the carrier's reported assets and liabilities for purposes of determining its available working capital the figure obtained relates to the company's entire operation. Some method of apportionment must be used to arrive at the amount of working capital reasonably assignable to the international division. TWA agrees with Bureau Counsel that the relative amount of cash operating expenses of the two divisions is a reasonable basis for making that apportionment for practically all items entering into the computation of working capital except for U. S. mail pay.

TWA submits that there can be no confusion concerning (a) the source of the mail pay receivable and (b) the ultimate use or disposition of it. In each case it is the international operations. It concludes therefore that this asset should be earmarked solely for that division in computing allowable working capital. TWA submits that the international division, since the start of operations in 1946, was continuously spending more than was produced by commercial revenues. Not only has that division been required to use all of the international mail pay to keep going, but it has also had to use some of the Domestic Division's funds derived from mail and commercial sources. In the light of such facts TWA contends that there is no basis for treating international mail pay as a domestic division asset.

Bureau Counsel suggests that TWA misconceives the working capital concept; that the existence of a substantial breakeven need is no indication of the existence of working capital. If all of a carrier's current assets are just able

to meet its current liabilities in a period of normal operations then it has little, if any, "working capital" for mail rate investment purposes. This appears particularly true of a transport industry where the bulk of income deriving from transportation

13128

service is prepaid and credited to earned income immediately upon rendering the service.[76]

We are here concerned, however, not with a determination of what the company as an entity had in the nature of working capital funds, but rather in making a constructive split of the corporate balance sheet between domestic and international divisions to arrive at a working capital allowance for the latter.

The basic difference between TWA's and Bureau Counsel's position on the issue hinges on the approach used, TWA emphasizing that the international division had a greater relative *need for* working capital than the domestic division. Bureau Counsel emphasizing that the relative net earnings of the domestic division were much greater than those of international and that the relative need for working capital is not controlling but rather the *source of available* working capital.

Bureau Counsel and TWA have agreed upon two factors which indicate an international *need for* working capital over and above the domestic requirements. One relates to mail pay receivables from foreign governments. The record established that there is a substantial lag of up to 10 months in receiving payment for such service, in contrast to a normal lag of about 1 month for collecting for domestic mail carried. The second area is in funds tied up in foreign banks pending approval of requests for con-

76 Contrast the working capital requirements of a manufacturing industry which must carry its expense for material, labor, etc., during production, shipping and normal billing periods before income for that product is received.

version to dollars. These appear to represent valid points of difference between the divisions as to their *need for* working capital. And along the same line it would follow that the international (U.S.) mail pay receivable, being substantially greater in amount than the domestic mail pay receivable for certain years and having to be carried for approximately 30 days[77] before payment, would create a relatively higher international *need for* working capital than for domestic. Analysis of these three items indicates that the international division *need for* working capital was thereby greater than domestic by amounts ranging from approximately $900,000 in 1946 to a high of about $2,300,000 in 1950.

But conceding, *arguendo*, that this greater international *need for* working capital is established, the question is then whether there are reasonable grounds for assigning such amounts to international before making allocation of the remaining *available* working capital between divisions on the basis of relative cash operating expenses. There is no disputing that working capital available to international, on the basis of a relative operating expense allocation between divisions of all system working capital, was well above the level of the higher international

working capital *need* relating to these three items. In connection with the issue as to the proper allocation for "working capital" purposes of U.S. mail pay derived from international operations TWA has submitted that proper tests are (a) the source and (b) the use. With respect to such international U. S. mail pay the answers are, of course, obvious. But what answers result if the same tests be applied to all working capital? The record

77 The question of under or over payment pursuant to temporary rates is not herein raised.

permits no complete answer. But it is clear that the three above discussed *needs for* (use of) higher international working capital are far from a complete analysis. The use of credit cards is much more extensive for domestic air travel than for international. The deferred payment thereby realized would call for a higher amount of working capital for domestic than international. No dollar measure of this item was presented. There are certainly many other similar items that were not advanced for consideration.

Looking at the other test suggested by TWA, the source of "working capital," an impossible task of analysis is presented. No party attempted it. During the period under review the investment, or capital, for the TWA system approximately doubled.[78] Such increase of invested capital came either from earnings, additional equity or additional debt. It is clear that the domestic operations were a source of appreciably higher earnings that the international. To the extent that increased equity or debt capital was put into the company in reliance on past earnings and future earnings prospects it would appear that the domestic division would again be a more significant "source" of this capital.

Again, the added system capital may or may not show up as "working capital." If it can be said that there was an allocable portion of the total for each division, it might still happen that one division would use a substantially greater part for equipment purchase, thus increasing its fixed capital rather than its working capital. In this connection the record shows that international twice replaced substantially all of its fleet with new aircraft during this period. While no definite evaluation of these factors can be made it appears generally that the increases of

78 Reported net worth plus long-term debt for the TWA system was $45,889,959 as of June 30, 1946, and $82,167,187 as of June 30, 1952.

invested capital derived more significantly from domestic operations than from international and further that the growth of investment other than working capital has been relatively greater for international than for domestic during the review period.[79] Perhaps the best summary of the international division's working capital situation is in TWA's brief; "Not only has the International Division been required to use all of the funds it received from U. S. mail pay to keep its International Division going, but it has also been required to use some of the funds produced by the Domestic Division, not only from mail but from commercial sources as well." The inference is clear that international used more than its share of corporate asset for expenses and expansion and that the source of working capital was principally the company's domestic earnings.

13130

The foregoing considerations cannot be found to support the result sought by TWA. Allocation of available system working capital between the carrier's two divisions must be made for purposes of this proceeding, and there is agreement that allocation based on relative cash operating expenses is generally proper. The specific deviation from this general formula urged because of differing need for working capital is not justified in the light of the dominant source of system working capital, and the adequacy of international working capital, when allocated from the system total according to such formula, to more than meet such needs. The position of Bureau Counsel is accordingly affirmed. • • •

• • • •

79 Recognized domestic investment other than working capital was approximately 31 million in 1947 and 33 million in 1950. Order E-5560, July 31, 1951. The comparable international investment recognized herein is approximately 17.5 million in 1947 and 22 million in 1950.

PAA—Past Period:

Mail compensation paid to PAA for its Atlantic Division during the review period has totaled $71,458,000 under temporary mail rates. Bureau Counsel's position is that the fair and reasonable final compensation for this period can be no more than $66,265,000, indicating an overpayment of $5,193,000. PAA contends for recognition of substantially higher expenses, investment and rate of return.

Under Utilization of B-377 and L-49 Aircraft:

As in the case of AOA, Bureau Counsel contends that PAA's early use of B-377 aircraft failed to achieve a reasonable level of utilization and that reported depreciation expenses should be adjusted to compensate for such sub-normal use. In the case of AOA the low utilization ran for a period of 8 months following their introduction into service. In the case of PAA it extends over an initial period of 15 months, from April 1949, with daily utilization of 0.6 hours, through June, 1950, when utilization reached 5.4 hours. The same considerations which were found to support Bureau Counsel's under utilization adjustments for AOA apply equally with respect to PAA in this period.

At a subsequent time, following the PAA-AOA merger, there also occurred a 6-month period during which the PAA utilization of both B-377 and L-49 aircraft fell below the 6.5 hour standard. Bureau Counsel would defer B-377 depreciation charges in the amount of $202,000, and capitalize and amortize

$83,000 representing hull insurance for this period. The comparable figures for the L-49 are $80,000 for depreciation and $40,000 for hull insurance. As to the L-49, however, the subsequent sale of certain of such aircraft by PAA yielded profits substantially in excess of the amounts here in issue and Bureau Counsel has agreed to the propriety of offsetting the proposed depreciation deferral against such profit before the inclusion of the profit in "all other revenue." There still remain in dispute the questions (1) whether the post-merger under-utilization should be governed by different considerations than were applied to the "initial service" under-utilization, and (2) whether the hull insurance attributable to the under-utilized L-49's in the post-merger period should be offset against profits from subsequent sales rather than capitalized and amortized.

PAA submits that the under-utilization doctrine, as developed by the Board, has been viewed in the nature of a pre-operating expense and that its extension to the circumstances present in the post-merger period creates artificial and dangerous special rules for further stretching the period of depreciation. PAA notes that as of the period immediately preceding the merger Bureau Counsel's approach would recognize 8.1 B-377's for PAA and 6.0 for AOA, a total of 14.1. In November 1950, the second month following the merger, PAA reduced its B-377 fleet to 14.2. Bureau Counsel objects to any determination made solely on the basis of the number of aircraft units because in the period following the merger PAA reduced the number of B-377 schedules previously operated by AOA, thus cutting daily utilization. In reply PAA submits that it was unexpectedly delayed in the inauguration of its service to Paris and Rome to the end of 1950 and was restricted as to frequency for a subsequent period. By

comparison with TWA, which was able to initiate its new service to London and Frankfurt in October of 1950, PAA contends that had PAA been able to operate B-377 services of comparable frequency to Paris and Rome in that period then its B-377 utilization would have met Bureau Counsel's standard.

Upon consideration of the factual situation here present it is concluded, in accordance with PAA's contention, that there is a substantial difference between the under-utilization in this post-merger period and that which occurred in the period of initial use of the B-377 which requires a different result. The period of low-utilization which not infrequently occurs when a new type transport aircraft is put into revenue service appears to be reasonably related to the advances in the art which are incorporated in such equipment. Operating and service problems arising in connection with such advanced equipment contribute to the low utilization. On the other hand, there is also a reasonable relationship between the advances in design which are incorporated in a new model aircraft and the period of useful life before later models render the earlier one obsolete. The selection of a new aircraft is made by management and there would appear to be compensating factors as between initial low-utilization and usable life attendant upon that selection.

13132

Again, the speed with which initial service problems are remedied would depend in substantial part upon the efficiency of the carrier in operations, engineering and maintenance. Such factors support the application of the under-utilization doctrine as employed heretofore in the period of initial service use of a new type aircraft.

As to the post-merger period these factors are not present. The aircraft were then operationally capable of

meeting the 6.5 hours daily utilization. The carrier was certificated to serve points which would support such utilization of its B-377 fleet. The essential cause of the underutilization was that international agreements needed to implement its new certificate authority to serve Paris and Rome were delayed. By April, 1951, these matters were satisfactorily resolved and there is no underutilization issue thereafter. In this situation it is clear that the six-month period of reduced utilization could not in any way add to the useful life of the equipment. And it is not contended under these circumstances that the carrier should have sold one or two aircraft in the fourth quarter of 1950, and replaced them in March of 1951. It is concluded that management action was properly economic and efficient in retaining such aircraft during this period. It is further held that no reasonable basis exists for extending the depreciation period for the underutilized aircraft and that recorded depreciation and hull insurance expense for such period should be allowed for rate making purposes. This latter holding is based principally upon considerations relating to rate of return. The inability to achieve reasonable utilization of the B-377 fleet in this period stemmed from a delay which could be encountered only in international service. Past Board decisions have indicated that international carriers should be allowed to earn a higher return on investment when future rates are fixed to allow for such risks. On the other hand the Board has applied the same rate of return for both international and domestic air carriers for past periods. Since the conclusion is hereinafter reached that the established 7% rate of return for past periods should be adhered to in this case, it follows that these reported expenses, which reflect a realized risk peculiar to international service, should be recognized as allowable expenses.

As was previously noted, the parties have agreed that

depreciation charges attributable to an underutilization of L-49 aircraft in this same period should be offset against profits realized from the subsequent sale of some of these aircraft.[86] There is disagreement, however, as to whether the hull insurance expense for such underutilized aircraft should also be offset against such profits, as PAA contends, or should be capitalized and amortized as Bureau Counsel submits.

It is first noted, as Bureau Counsel submits, that there is an essential difference between the two types of expense, depreciation and hull insurance. The former is an estimate, the latter is a firm amount. The sale of an aircraft at a price other than its depreciated book value establishes *prima facie* that the estimated rate of obsolescence as reflected by the depreciation recorded was in error. The agreement of the parties to make an offset of depreciation charges proposed for disallowance against subsequent profits

13133

realized from the sale of the aircraft concerned is to effect a partial correction of that error. But there is no error in recorded hull insurance expense. It is a certain expense prudently incurred to protect the carrier's investment in flight equipment. To the extent that such expense attaches to an aircraft which is found not "used and useful" for the carrier's operations it would appear proper to capitalize that hull insurance charge for the period concerned, adding the amount to the aircraft's book value. If the aircraft thereafter returned to a "used and useful" status the capitalized hull insurance would be recovered through depreciation charges. If the aircraft were thereafter sold the higher book value representing the capitalized hull

86 Following the merger in September 1950, PAA sold 4 L-49 Constellations: 1 in December, 1950, 1 in January 1951 and 2 in May 1952. The number of L-49's assigned to PAA's Atlantic Division dropped from 15.9 in October, 1950 to 9.9 in July, 1951.

insurance would operate to reduce the profit on sale. Such disposition of the hull insurance issue is, of course, complicated by the facts that there are no identified "underutilized" aircraft, that hull insurance expense is charged against the total operations of a given aircraft type, and that aircraft of a given type are transferred between divisions. But in the case at hand it is clear that 2 of the 2.6 L-49's which were not "used and useful" in the 4th quarter of 1950 were sold without returning to a "used and useful" status. As to these 2 aircraft the hull insurance for that quarter should be offset against the profits from their sale. As to the remaining underutilized L-49 aircraft—0.6 in the 4th quarter 1950, 1.6 in the 1st quarter 1951 and 1.0 in 2nd quarter 1951, it is clear that they did not return to a "used and useful" status in PAA's Atlantic Division (L-49's in the Atlantic Division were 15 for the 4th quarter 1950, 11.8 for the first quarter 1951, 11.0 for 2d quarter 1951 and 9.9 for 3d quarter 1951). Presumably the declining number of such aircraft in this division, except for the two which were sold, reflects transfers to other PAA operating divisions. In such case the $26,038 representing hull insurance for these underutilized aircraft should also have been transferred, capitalized and amortized over the remaining useful life of the aircraft. But this was not done and the other divisions are now on mail rates which did not provide such expense. To avoid inequity a provision for capitalization and amortization of this amount will be made herein, employing a five-year period for amortization.

PAA has expressed a further objection to the deferrals for mail rate purposes of depreciation and hull insurance in connection with income taxes. The objection is, as to the amounts to be deferred (approximately 1 million dollars), that PAA reported this as expense in the year it was recorded on its books and accordingly took a tax saving of almost one-half of that amount. The mail rate herein

will be set on the basis of the taxes actually paid, thus taking the benefit of this reduced need. The depreciation and hull insurance amounts which were taken as tax deductions in the past will not be again deductible in the future because of deferrals or amortizations established herein for mail pay purposes. Accordingly PAA foresees greater tax liability in the future than is provided for by the normal forecast.

The short answer to this contention is, of course, that the future mail rate will make allowance for the carrier's demonstrated need. Established practice relating to future mail rates has been to base that rate on a forward projection of 1 year. Most of the difficulty foreseen by PAA relates to a period beyond that one year. But it is not reasonable or necessary to attempt to assess the prospects of the more extended future. The intangibles increase as the period expands. The future rate based upon one future year may or may not remain reasonable for additional years. If it does not, the carrier, the Postmaster General or the Board is free to reopen the rate and request appropriate revision.

13134

Excess Capacity:

Bureau Counsel contends that PAA operated an excessive volume of scheduled passenger service during 1949 in its New York-London, London-Damascus, Damascus-Basra and New York-Bermuda operations. Disallowance of such excess capacity would reduce PAA's claimed need mail pay by $900,000.

Illustrative of Bureau Counsel's approach is the U.S.-European Gateway operation. Capacity provided by PAA in this area for the years 1948, 1949 and 1950, by quarters, is as follows:

(13134)

Standard Available Seat Miles (000)

	1Q	2Q	3Q	4Q
1948	48,029	62,075	82,464	48,320
	(77)	(100)	(133)	(78)
1949	42,557	65,983	105,582	70,090
	(65)	(100)	(160)	(106)
1950	46,854	69,585	92,403	100,965
	(67)	(100)	(133)	(145)*

* Reflects AOA-PAA Merger

The figures in ( ) provide an index of the available capacity based upon the 2d quarter of each year. It is noted that the capacity provided in the 3d quarter of 1949 is substantially higher than that operated in either 1948 or 1950 both in absolute size and also in relation to the earlier quarters. The same observations apply in comparing the 4th quarter of 1949 with the 4th quarter of 1948. Bureau Counsel submits that PAA has established no reason for this unusually large expansion of capacity in the 3d and 4th quarters of 1949.

Looking next to the traffic results for 1949 the analysis of passenger load factors, by quarters and equipment types, is as follows:

Passenger Load Factor (%)

1949	B-377	L-49	DC-4	Over-All
1st Q	—	58.7	44.2	56.7
2d Q	83.7	77.7	35.4	65.2
3d Q	71.8	60.7	39.4	58.1
4th Q	64.8	54.4	31.9	55.9
Year	69.0	64.0	37.2	59.0

The over-all load factor for the year, 59%, is substantially lower than the 63.2% achieved in 1950, or the 66.0%

reached in 1951. Again, the usual load factor pattern by quarters, as indicated by PAA's operations in other years and by operations of TWA and AOA, shows that the 3d quarter

13135

is about the same as, or slightly above, the 2d quarter figure; the 4th quarter load factor normally approximates that of the 1st quarter. Bureau Counsel concludes that the load factors attained in the 3d and 4th quarters of 1949, particularly those for the DC-4 and the L-49, were unreasonably low and fail to justify the abnormally high volume of service operated. The adjustment proposed would eliminate 3d quarter capacity in excess of 133% of that for the 2d quarter, and 4th quarter operation of 30 DC-4 round trips. The revenue loss that would flow from the reduced capacity was estimated on the basis that the remaining PAA DC-4 and L-49 flights would have realized load factors comparable to those of AOA and TWA on similar equipment in the quarters concerned. Expense reductions estimated for the excess capacity were on the basis of experienced direct costs and approximately 50% of indirect costs on the basis of appropriate units. The net amount proposed for disallowance relating to this U. S.-European Gateway area is $482,000. Similar analyses of the other excess capacity areas lead to proposed disallowances of $99,000 for the London-Damascus operation, $78,000 for the Damascus-Basra service and $241,000 for the New York-Bermuda area, a total of $900,000.

This analysis and proposal of Bureau Counsel is not without merit and is one which is consistent with Board action in prior proceedings. However, it is concluded that this approach should not be employed in this case with reference to the U. S.-Europe-Asia sector because of another disallowance proposed herein by Bureau Counsel

which relates generally to PAA need in excess of that of TWA over this sector for the years 1948-1952. In this larger period of 5 years there were several during which PAA's passenger load factors averaged higher over these segments than did those of TWA. If PAA is to be disallowed generally its need in excess of TWA's for this larger period it is only proper that its efficiency in matching capacity to traffic be judged in the same perspective, which may, in effect, permit some offset of its relatively less efficient scheduling of capacity in 1949 against comparatively superior scheduling in other years.

The foregoing reasons for rejecting a specific analysis of alleged excess capacity in 1949 do not apply to the PAA U.S.-Bermuda operation. During that year PAA scheduled an average of almost 13 round trips a week between U. S. points and Bermuda. It achieved a passenger load factor of 51.1%. Bureau Counsel submits that in this operation the carrier can readily anticipate the traffic demand, that reservations are made substantially in advance of travel, that there is essentially no directional unbalance, and that, since it is largely tourist travel, there is substantial flexibility with respect to travel dates. Bureau Counsel proposes that PAA be held accountable for passenger load factors averaging 65% for its New York-Bermuda service for 1949.

PAA does not contest the proposed capacity adjustment entirely and has indicated agreement to an adjustment which would recognize minimum scheduling of 1 daily round trip New York-Bermuda, 2 weekly round trips

Boston-Bermuda, with disallowance of trips in excess of such minimum to the extent necessary to reach a 65% load factor. Using Bureau Counsel's costing approach this would result in a disallowance totaling $174,000, which is

$56,000[87] less than the amount proposed by Bureau Counsel.

The $56,000 difference reflects one essential disagreement with respect to the 65% load factor. Bureau Counsel contends that it should be based upon *actual* available seats. PAA based its proposal on the use of *standard* available seats, and a 65% load factor on such basis is equivalent to an actual revenue passenger load factor of 61.8% in the 1949 Bermuda service. As Bureau Counsel contends, the use of "standard" seating capacities of the various aircraft used by the parties hereto is to avoid the complications that would result from basing comparisons on actual seating arrangements with minor configuration differences between the carriers, with allowances for extra crew requirements on long hops and directional differences. In the Bermuda operation such factors are not present and accordingly the actual seating capacities should be used. Thus the issue is whether a reasonable standard for revenue passenger load factor in this service is 61.8%, as PAA contends, or 65%, as Bureau Counsel contends. It is concluded that the latter, 65%, is a reasonable requirement.

Actual load factors experienced by PAA in its Bermuda service averaged 86.1% in 1947, 79.6% in 1950 and 76.7% in 1951. These high annual load factors attest to the fact that this market is outstanding in traffic balance and flexibility. PAA's low load factors of 59.4% for 1948, and 51.1% for 1949 are substantially out of line with these other years and appear to coincide with the effective impact of competitive U. S. service by Colonial Airlines, which began New York-Bermuda operations in 1947. Bureau Counsel has not challenged PAA's 1948 Bermuda

---

87 The $241,000 figure contained in Bureau Counsel's final exhibits and brief appears to be excessive by $11,000 because of the use of a basic figure supplied by PAA which was later corrected. Bureau Counsel's witness agreed that the correction was proper but apparently failed to adjust the proposed disallowance to $230,000 through oversight.

capacity (load factor) and it appears proper to accept the actual results for that year as one in which the competitive effort and capacity adjustments are reasonable. But such considerations cannot be extended into 1949. In a market such as this, where daily round trips are scheduled, with additional frequency in many months of the year, the continued debasement of load factor by the scheduling of added capacity cannot be underwritten as an efficient management action.

PAA submits that this result overlooks the surface (boat) competition which became particularly active and effective in 1949, to such an extent that, though total U.S.-Bermuda travel had a normal growth in that year, the number of air passengers actually declined from the prior year's

13137

level. This factor is not found to merit substantial weight, though in its absence it is believed that a standard somewhat above a 65% load factor would be justified.[88] But the proper management action to meet such competitive effort would appear to be in the realm of sales promotion rather than in service capacity. Accordingly it is held that, to the extent that PAA operated in excess of the minimum frequencies previously set forth, it should be held to an actual revenue passenger load factor of 65%.

There is some dispute as to whether Bureau Counsel's adjustment, being based upon PAA's proposal with general correction from the *standard* to the *actual* load factor basis, operates to reduce the allowed plane mileage below the minimum frequencies for 5 months of the year. It is found that the method used does effect such result, and

88 Analysis of U.S.-Bermuda traffic trends set forth in a 1948 mail rate decision for Colonial indicated the propriety of a load factor approximating 68%. *Colonial Air, Bermuda Mail Rates*, 9 C.A.B. 20, 25 (1948).

that it is improper to that extent. Correction for this item reduces the disallowance by $16,000. To the extent that there was disagreement relative to the proper costing of the disallowed capacity it is found that the basis used by Bureau Counsel, much of which was on an added cost basis, was reasonable. It is accordingly found that the excess U.S.-Bermuda capacity operated by PAA in 1949 requires disallowance of $214,000 of reported expenses.

Bermuda Service, 1951:

PAA's breakdown of its mail pay claim indicates a breakeven need of $453,000 for its Bermuda operation for the year 1951. In his exhibits proposing the foregoing disallowances based on excess capacity Bureau Counsel initially indicated that $408,000 of that amount should be disallowed for 1951. This initial proposal of Bureau Counsel was based essentially on full cost allocations. A subsequent revision of the costing method to base the disallowance on added costs for the indirect cost items indicated that no disallowance for excess capacity would result.

As was previously noted PAA achieved an actual average revenue passenger load factor of 76.7% in that operation; 76.8% in regular service and 76.6% in tourist service. These are high average load factors and it is believed clear that if there is to be any disallowance of PAA's 1951 Bermuda claim it cannot rest on the basis of "excess capacity" in the normal sense, i.e., unreasonably low load factors. In subsequent revisions of exhibits, however, Bureau Counsel proposed to eliminate all of PAA's Bermuda need for 1951 on the basis that Colonial, the smaller carrier and the most recent in that market, had been able to operate its Bermuda service at a profit before mail pay in that year. This is Bureau Counsel's position on brief. In addition, Bureau Counsel takes issue with PAA's allocations of expense to this service and submits that

the need to be disallowed is properly computed at $611,000, rather than $453,000.

Considering first the question of whether PAA should be denied any breakeven need for the 1951 Bermuda service, it is the carrier's position that section 406 of the Act requires that PAA's mail rate must be fixed in accordance with its *own* situation and requirements, and not in accordance with those of Colonial Airlines. PAA asserts that the difference in need as between Colonial and PAA in this service can be clearly identified and that it is primarily attributable to the difference in the types of equipment used. Colonial operated only DC-4 tourist service; PAA operated a comparable tourist service, but also operated more modern aircraft (some B-377's, but principally L-49's) in first-class service. Thus PAA submits that the question to be decided is whether PAA, like Colonial should have operated only DC-4 tourist service to Bermuda. It contends that its operation of the more modern L-49's and B-377's is in accord with the policy of the Act—the encouragement and development of an improved air transportation system—and accordingly must be recognized for mail rate purposes.

Bureau Counsel submits that the more modern aircraft should have paid their own way in competition with the DC-4's and that PAA should have been able to adjust seating density, fares, or the volume split between tourist and regular service to achieve that result.

It was previously noted, in the section dealing with the selling expense issue for TWA, that PAA had made a comparative cost study of the C-54, L-49 and the B-377 prior to purchase of the latter and had concluded that the B-377 would be the most economical aircraft.[89] In that

[89] See p. 90, *supra*.

analysis the C-54 ran a poor third, and it should be noted that the analysis allowed for rental of the C-54 at $3,000 per month, as compared to monthly depreciation charges of approximately $8,000 for the L-49 and $15,000 for the B-377. That analysis showed a C-54 cost per revenue mile of $1.46 (at a 1,500 mile range; $1.59 at a 1,000 mile range). Colonial's reported costs in its 1951 Bermuda service were appreciably above the PAA figure—$2.01 per revenue plane mile. About 8.5 cents difference is attributable to the excess of Colonial's actual depreciation charges over PAA's assumption. Of course, Colonial operated its Bermuda DC-4 tourist service with a higher seating density (52) than had been contemplated by PAA (42) in its analysis. It is clear that such increased seating capacity was a critical factor in making Colonial's Bermuda operation profitable in 1951.

PAA also used a high seating density in its DC-4 Bermuda tourist flights—an average of 53.9 seats in 1951. But its regular fare service, using some B-377's, but primarily the L-49, the average seating density was only 50.5. The data of record does not contain a breakdown of PAA's Bermuda expenses for 1951 by aircraft types. However, if we assume that

13139

PAA's DC-4 costs per plane mile were the same as Colonial's and that B-377 costs were 1.5 times those of the L-49, we obtain indicated costs per revenue plane mile of $3.57 for the L-49 and $5.36 for the B-377.[90] Such indicated

[90] Revenue plane miles in tourist service and in total, total claimed expenses, and the percentage of B-377 and L-49 miles in regular service are of record. Combined with the above assumptions the resulting figures are:

	Rev. Plane Miles	Cost per Rev. Mile	Total Cost
DC-4	601,000	$2.01	$1,208,000
L-49	602,000	3.57	2,148,000
B-377	104,000	5.36	558,000
	1,307,000		$3,914,000

operating costs for these later type aircraft are grossly excessive, judged by any standard, and indicate a comparable degree of inefficiency. If PAA's 1945 analysis of comparative per mile costs for the three aircraft was reasonably correct, and the evidence of record tends to substantiate it, then, on the basis of Colonial's per mile costs for the DC-4, PAA should have been able to achieve per mile costs of approximately $2.12 for the L-49 and $3.18 for the B-377, total costs of $2,815,000 and a profit before mail pay of about $646,000. It will be noted that the figure of $2.12 per mile for the L-49 is still appreciably higher than the 1951 adjusted figure for TWA's L-749A aircraft of $1.84. And the TWA figure includes international operations which require multiple crews and incur higher fuel costs than the Bermuda operation.

The above figures to the extent that they are expressed as relating to the PAA Bermuda operation of a particular type aircraft are not necessarily correct. But to the extent that they overstate the carrier's inefficiency with respect to one type they understate it with respect to another. The net indication of excessive costs is reasonably portrayed. It is held, in accordance with the position of Bureau Counsel, that any break-even need claimed by the carrier for its Bermuda operation in 1951 and later years resulted from uneconomic and inefficient management and must be disallowed for mail pay purposes.

There still remain certain arguments of PAA which it contends should be held to reduce the amount of disallowance. One relates to the level of fares. PAA notes that Colonial, upon initiating tourist service, established a round trip fare of $85.00. PAA's regular fare was previously $126.00 and the carrier considered the difference to be too great and accordingly established a first-class excursion fare of $99.00. It is difficult to assess with pre-

cision the effect of competitive fares and services. In the case of domestic carriers the Board has adhered to a policy which calls for coach fares not higher than 75% of the first-class fare.[91] PAA's reduction of

13140

its first-class fare to $99.00 placed the coach fare at a level of 86% of first class. A first-class fare of $113.00 would have placed the coach fare at the 75% level. But it is not necessary to speculate on what traffic shifts might have occurred if such a differential had been maintained. The level of rates was determined by PAA management. Even at the rate structure established with the seating configurations actually used, with similar passenger load factors on the tourist and first-class flights, PAA would have realized a profit from all Bermuda services in 1951 if it had maintained its costs at reasonable levels. If relative costs between the three equipment types had further been in accord with its 1945 analysis then the first class service would have produced larger profits than the tourist flights. There accordingly appears no basis for adjustment based upon the fare structure.

PAA further contends (1) that 1952 profits on the sale of two L-49's should be applied to offset that part of the disallowance representing L-49 depreciation charged to Bermuda service in 1951, $196,000: (2) that if compared with Colonial for the 1948-1951 period as a whole PAA's need per revenue ton mile is well below Colonial's and hence should be allowed, and (3) that PAA's Bermuda service in 1951 produced income to the U. S. Government in the form of transportation taxes in excess of the indicated break-even need and should be allowed as an offset.

---

91 The Board's power to prescribe lawful fares, set forth in sec. 1002(d) of the Act, does not extend to foreign air transportation.

(13140, 13141)

The transportation tax assertion is a novel contention and clearly without merit. Its request for long term comparison with Colonial would give PAA the substantial benefit flowing from its established position in this market in those early years when Colonial was unable to attract traffic in sufficient quantity to approach the PAA load factors. If break-even need comparisons for 1948-1950 be made on a total dollar basis, which appears reasonable for this specific directly competitive operation, rather than on the need per revenue ton-mile basis urged by PAA, then it appears that PAA's recognized need, even after the 1949 disallowance, is greater than Colonial's for these years.[92] The requested offset of 1952 profits from the sale of two L-49 aircraft has some surface merit, but must be rejected. The earlier holding which permits the offset of sale profits against proposed suspension and deferral of underutilized aircraft operates to maintain the established 7-year period of depreciation and as a result tends to affirm the reported depreciation charges. In the Bermuda operation there is no indication that the carrier's excessive costs were related in any way to the depreciation account. Thus to permit the requested offset would in effect let the carrier apply sales profits, which are labeled as abnormal by adherence to the standard 7-year depreciation period, to compensate for the carrier's inefficiency in other expense categories. This action is not warranted. Accordingly, there is found no merit in PAA's further contentions for adjustment of its 1951 Bermuda break-even need.

13141

There still remains Bureau Counsel' contention that the need here involved is properly $611,000 rather than $453,000 as presented by PAA. The difference arises es-

92 1948-1950 break-even need for Colonial's Bermuda service is $1,464,000, PAA's totals $1,476,000.

sentially from cost allocations between the various segments comprising the total PAA Atlantic Division. If the cost allocations in dispute would affect the ultimate decision on PAA's mail rate for the past period they would, of course, be weighed and decided. But by accepting PAA's allocation as to Bermuda the effect is only to leave the additional amount questioned by Bureau Counsel in PAA's transatlantic segment. Later issues find disallowance of greater amounts required for those operations. Accordingly, it is determined that the 1951 PAA claim for its Bermuda operation, in the amount of $453,000, must be disallowed in its entirety under the standards of the Act.

Paris Capacity, 1952:

PAA initiated service to Paris in January, 1951. By the middle of that year it was serving the New York-Paris market with daily B-377 flights. In the fall of the year both TWA and Air France reduced schedule frequencies to match the normal seasonal traffic decline. Air France still scheduled daily service, TWA about 13 weekly round trips. PAA did not reduce its daily schedule frequency, but did, for the period January 3 through March, 1952, reduce the seating capacity of its B-377's from 61 to 47 seats. Bureau Counsel contends that PAA's failure to reduce to 6 weekly round trips, maintaining standard seating, was uneconomical and inefficient and calls for disallowance of the cost of the 7th weekly trip during this period with adjustment for revenues that would thereby have been lost. The amount in issue is $88,000.

PAA vigorously opposes any disallowance. It contends that the continued operation of a daily service was essential to maintain its position in the Paris market, and further, that the singling out of its Paris service for dis-

allowance is improper since Bureau Counsel has made no similar proposal with respect to TWA's daily service to London and thirteen weekly round trips to Paris, both of which averaged lower load factors than PAA's daily service to Paris.

* * * *

There is no intent to by-pass or indicate approval of PAA's action in reducing the seating capacity of the B-377 aircraft. In the recent decision in the PAA Latin American Mail Rate Case[93] the Board expressed its disapproval of such practices and made disallowances of reported need resulting therefrom. A similar conclusion would be reached herein * * *.

* * * *

Engine Maintenance Expense, 1949-1950:

Bureau Counsel contends that PAA's reported maintenance expenses for the R-3350-BA (L-49) engines and the R-4360 (B-377) engines were

13142

in excess of a reasonable level by approximately 1 million dollars[94] for the years 1949-50, which amount should not be underwritten with mail pay. The basic figures relied upon by Bureau Counsel are as follows for maintenance expense per engine hour:

---

93 Statement of Provisional Findings and Conclusions, Order No. E-7441, June 5, 1953, made final by Order No. E-7495, June 19, 1953.

94 The proposed disallowance totals $1,000,320, of which $653,414 relates to the L-49 engines and $346,906 to the B-377 engines.

R-3350-BA (L-49) Engine—

	TWA System	AOA	TWA-AOA Average	PAA	PAA Excess
1949	$8.36	$ 8.55	$8.45	$14.07	$ 5.62
1950	8.61	11.38	9.99	8.07	—1.92
1949-50 Weighted Average			9.00	11.30	2.30

R-4360 (B-377) Engine—

	AOA	PAA	PAA Excess
1949	$18.48	$22.20	$3.72
1950	19.36	22.57	3.21
1949-50 Weighted Average			3.33

The above figures incorporate certain adjustments which are not in dispute, and some which are. AOA did not perform its own engine overhaul work, consequently the contractor's charges for overhead and profit have been eliminated. Such adjustments are not in dispute. The TWA data for the R-3350-BA engine covers essentially a period of domestic use and PAA submits that several factors warrant an allowance of at least 5% and probably 10% to compensate for cost differences between domestic and international operations relating to maintenance. Bureau Counsel has recognized only a 1% differential for this factor. With respect to the R-4360 (B-377) engine PAA submits that there are apparently differences in definition for accounting purposes between AOA and PAA as to maintenance chargeable as (1) engine, (2) aircraft, and (3) other. PAA therefore submits that a proper comparison must include all three maintenance subdivisions which shows that PAA had B-377 hourly maintenance costs below those of AOA for 1949-50. Bureau Counsel opposes the overall comparison of B-377 maintenance costs

as between PAA-AOA on the grounds that (1) PAA's "aircraft" maintenance costs were not lower than AOA's when the cost of PAA's ferry flights to Miami are included, that (2) AOA's "other" maintenance includes many items of work which were performed under outside contract and PAA has failed to adjust reported data to eliminate their overhead and profit, and (3) all AOA records are in PAA's possession and the carrier failed to present any specific evidence to show AOA-PAA differences in accounting charges for engine maintenance.

13143

The essential question presented is what is a reasonable standard for judging PAA's efficiency in this aspect of its operations. If with respect to the R-3350-BA, PAA were held to the cost level experienced by TWA, even allowing a 5% difference for international operations, the proposed disallowance would be larger than it is. PAA has shown that for the years in question TWA's average hours between overhaul were 4.25% greater than PAA's for this engine. But engine overhaul costs constitute approximately 40% of the larger category of engine maintenance costs which are here compared, so that this factor, giving it full credit as attributable to international versus domestic use, would account for only 1.7%.[93] In justification of the balance of its claimed 5 to 10% differential PAA has generally asserted that maintenance at foreign points is more costly because of higher wage scales and lower effective utilization of personnel because of the lower frequency of operations. While the latter point may have some general validity it cannot be quantitatively measured. The record does not support the former assertion. But if

[93] The 1% allowance made by Bureau Counsel derived from data for other carriers operating both domestically and internationally. In any event it was allowed PAA in comparison with an AOA-TWA average which is 6% higher than TWA experience.

the allowable PAA level were to be based on a TWA-PAA comparison alone it is clear that no more than a 5% differential would be justified.

The comparative base employed by Bureau Counsel gave the adjusted experience of TWA and AOA equal weight. Actually the scale of PAA's L-49 operations was closer to that of TWA than to AOA[96] so that if there is a cost saving with volume operations the base should have been weighted heavier toward TWA's experience. Again, AOA's overhaul work was performed outside its own shops, and presumably if its scale of operations had justified establishment of its own overhaul facility it would have achieved a reduction of those costs. It, accordingly, appears that Bureau Counsel's position, giving AOA's experience a 50% weight, results in a comparative base which is more liberal than might have been properly used. It thereby incorporates some latitude above the experience of the carriers used for comparative purposes and establishes a reasonable upper limit for disallowing PAA's still higher costs.

The foregoing considerations relate to Bureau Counsel's comparative base (TWA-AOA) for the R-3350-BA (L-49) engines. But to the extent that they indicate a size disparity between AOA and PAA they are also valid with respect to the proposed PAA disallowance for the maintenance of R-4360 (B-377) engines. PAA's B-377 hours were approximately twice those of AOA for the two years concerned. It overhauled its own engines at a large maintenance base in Miami, whereas AOA's were overhauled by outside contract. In the absence of more specific PAA evidence to support its contention that engine maintenance accounting differed as between it and AOA the compari-

96 L-49 engine hours were approximately as follows (in thousands):

	TWA	PAA	AOA
1949	312	191	63
1950	162	152	76

son proposed by Bureau Counsel appears reasonable. Again, with

13144

equally efficient management and the above-cited differences in size and method of maintenance operation the PAA costs should be lower than those of AOA. Holding PAA to the cost level achieved by AOA is a liberal standard. It is accordingly held that the disallowance of $1.000,320 of PAA's reported engine maintenance expense for 1949-1950 is required under the standards of the Act.

Maintenance Ferry Flights:

From 1949 through 1951 PAA ferried Atlantic Division aircraft between New York and Miami for their No. 3 service. Bureau Counsel submits that the practice was inefficient and proposes to disallow the expense of 545[97] such ferry flights in the amount of $550,045.

The No. 3 service is of relatively high frequency, occurring about once every two months for aircraft with normal utilization. The present required period for such service is every 425 hours for PAA's B-377's and every 525 hours for its L-49's. In actual operation these limits are not attained and the average elapsed time between No. 3 services has ranged between 300 and 500 flight hours. As performed by PAA the No. 3 service has required approximately three days and uses about 2,000 man-hours for the B-377 and between 1,000 and 1,300 man-hours for the L-49.

Prior to 1949, PAA performed its No. 3 service for Atlantic Division aircraft at New York. The change in 1949 followed the establishment of its large maintenance and overhaul base in Miami in 1948, and coincided generally with its introduction of the B-377 fleet. Following

97 Certain additional flights for No. 3 service were operated as charters and are not questioned. New York-Miami Ferry flights for No. 4 or highly numbered maintenance service is also not questioned.

the PAA-AOA merger in 1950 the No. 3 services were again performed in New York for about eight months because of the overload of modification work at Miami on the acquired AOA aircraft.

In considering this issue it is necessary to understand that a "No. 3 service" is not a rigid or standardized quantum of inspection and maintenance work. There are, of course, certain minimum requirements. But over and above that minimum there is substantial latitude for management to schedule various inspections or maintenance operations at the time of lower numbered (higher frequency) services or, to some degree, at the time of higher numbered services.[98] This is well illustrated by a comparison of TWA's 300 man-hour requirement for its No. 3 service on L-49 international aircraft as against PAA's 1,000-1,300 man-hours for the same type aircraft.

PAA has raised several points in support of its decision to perform No. 3 services at Miami but they cannot be found to have significant merit. PAA's principal contention is that the complexity of the B-377 required specialization of mechanics, inspectors, etc., that such personnel could not be effectively assigned to work on other air-

13145

craft types, and that performance of the No. 3 service at New York would have resulted in substantial idle time for such personnel both at Miami and at New York. But such an assertion cannot be accepted. Bureau Counsel submitted in evidence statements from both Northwest Airlines and United Air Lines to the effect that B-377 maintenance employees were trained to work on other aircraft types when work on the Boeings was not available. PAA's own contention re the complexity of the Boeing appears in itself to necessarily imply that employees who were com-

98 The No. 1 service for PAA is a 100-hour service. The highest numbered is a No. 8, required at 8,000 hours, which is a complete major overhaul of the aircraft.

petent to qualify for B-377 work would clearly be competent to work on less complex aircraft when given the requisite familiarization and training. Insofar as the New York servicing is concerned, when the Nos. 1 and 2 operations are added to the No. 3 service, it is found that there would be little, if any, need for switching B-377 specialists to other aircraft types. The eight-month period from October 1950 through May, 1951 when PAA performed these three services in New York substantiates this conclusion. The need for diversifying the specialists would then exist only with respect to the Miami base. Such diversification would not, of course, present any difficulty for many members of a maintenance crew, cleaners, helpers, inspectors. As to the more specialized workers on electrical, hydraulic or other systems the diversification might be accomplished by training them for shop repair, overhaul and testing of the system components when aircraft were not available. Considering all such aspects of the issue it is concluded that PAA's contention re specialization does not merit the weight necessary to justify its past practice of ferrying aircraft to Miami for the No. 3 service.

PAA's other objections to Bureau Counsel's presentation merit but brief mention. Bureau Counsel presented exhibits analyzing an actual 60-day service pattern for PAA's Miami base to demonstrate that the performance of the No. 3 services at New York would still maintain a good continuity of aircraft for service both at Miami and at New York. PAA objects to the fact that Bureau Counsel found it necessary to make certain shifts of a few days for some aircraft services to achieve that result. But Bureau Counsel's adjustments were not of major significance. Granted that service scheduling and route scheduling must be closely correlated to achieve good utilization and avoid premature servicing, the adjustments made appear well within the carrier's margin between actual hours between specified services and allowable time limits.

PAA submits that the performance of No. 3 services at New York would have required additional hangar space there at a cost of about $100,000 per year. If the contention has any merit it would only be for the period prior to August, 1950 when PAA acquired hangar space at Idlewild airport. About two months later it acquired additional hangar space when the AOA merger went into effect. But prior to 1949 PAA performed all services on its Constellations and DC-4's at LaGuardia. With the removal of the No. 4 and higher numbered services from there to Miami it would appear that the same LaGuardia facilities should have been able to accommodate the additional No. 3 services for the B-377. Reference to the low daily utilization of

13146

the B-377 in 1949 and the first half of 1950[99] would indicate that the hangar space needs for Nos. 1, 2 and 3 services would have been appreciably less than normal in this period. While PAA has generally asserted that the LaGuardia hangar space was inadequate and overcrowded in this period it has not furnished specific data relative to its capacity and use to refute the foregoing.

PAA asserts that the performance of No. 3 services at New York would have required additional non-mechanical personnel, engineers and stock clerks, and additional stocks of supplies and parts. Considering the fact that New York was the carrier's main operating base for the Atlantic Division and was set up to perform lower numbered services the validity of the assertion appears questionable. In any event there should have been some compensating reductions at Miami and opportunity to avoid duplication of equipment and spare parts through appropriate modification of the content of the No. 3 service.

---

99 See discussion of Under-Utilization issue, p. 121.

(13146)

With respect to the computation of expense attributable to the ferry flights in issue PAA and Bureau Counsel differ by about $85,000 with respect to the proper charge for indirect maintenance. Neither party proposes a full allocation of the indirect maintenance expense for the flight hours involved. Bureau Counsel would set it at the level employed in costing all-cargo operations. PAA would reduce it below that level on the theory that the indirect expense of the Miami base would have to be higher per unit for the lesser volume of work handled if the No. 3 service were performed in New York. It is concluded, however, that Bureau Counsel's figure is reasonably conservative in computing the costs to be disallowed. It is noted that Bureau Counsel has not proposed any adjustment of such expense on the basis that revenue hours between service could have been increased to some extent in the absence of the ferry flights.

Both parties are agreed in principle that in disallowing the cost of the ferry flights there should be an offset made to construct a cost of trucking engines between New York and Miami for overhaul, which engines were on the ferried aircraft. PAA claimed $169,000 for this offset, but this was based upon trucking all engines removed at Miami for overhaul at the time of No. 3 service during the period. Bureau Counsel has not proposed any cost disallowance for No. 3 service flights which were flown under charter • • •.

PAA finally submits that the chartering of many of its New York-Miami flights which was accomplished in late 1950 and throughout 1951 served to eliminate ferry expense for flights other than those for No. 3 service. With constructive elimination of the No. 3 ferry flights PAA submits that the remaining flights would have been so reduced in frequency as to render it doubtful that their charter could be arranged. The point is debatable, but

there is no evidence of record to indicate that a normal relationship between supply and demand would be destroyed in this instance by the lower frequency.

13147

In accordance with the foregoing it is conluded that the performance of No. 3 service on Atlantic Division aircraft at PAA's Miami base in 1949, 1950, and 1951 was an uneconomic and inefficient action and the excess expense thereby incurred * * * must be excluded from recognized need under the standards of the Act.

Excess Constellation Engines:

Bureau Counsel proposes to disallow reported depreciation expense for certain R-3350-BA (L-49) engines in the years 1947 through 1952 on the basis that the number of such engines was excessive, hence not "used and useful" under economical and efficient management. The depreciation expense to be disallowed totals $434,580. There would be a corresponding reduction of claimed investment.[100]

Bureau Counsel's proposal would recognize for PAA a ratio of spare to installed engines for these years of 100%. The actual ratios for PAA in this period ranged between a low of 125% in 1947 to a high of 152% in 1949. TWA's

---

100 Claimed depreciation and investment proposed for disallowance, by years, are as follows:

	Depreciation	Investment
1947	$52,056	$289,140
1948	80,847	470,651
1949	89,955	382,408
1950	67,939	254,471
1951	58,041	164,132
1952	85,742	55,211

By agreement of the parties this issue includes amounts assignable to PAA's Latin American Division—$107,606 of depreciation and a comparable portion of investment.

ratio of spare to installed engines for L-49 aircraft was 75% or lower during the period. AOA's was constant at 82% from 1947 to the end of operations in 1950. The great bulk of TWA's operation with the L-49 in this period was in domestic service and consequently Bureau Counsel does not base his comparative evaluation of PAA in any substantial degree on those results. But AOA's L-49 operation was in transatlantic service and Bureau Counsel submits that it affords a proper comparative base to check the reasonableness of PAA's spare engine needs. During the period in issue PAA operated a minimum fleet of 14 L-49's as compared to AOA's 7. Both carriers had their engine overhauls performed by the same outside contractor in 1947 and the first half of 1948. AOA's overhaul work continued on that basis thereafter, whereas PAA subsequently performed its own engine overhauls at its Miami base. Such factors, on their face, appear to support Bureau Counsel's contention that PAA should reasonably have been able to operate with a spare engine ratio approximating that of AOA. Bureau Counsel's proposed 100%

13148

spare ratio for PAA is, of course, 18 percentage points higher than AOA's experience.[101]

PAA opposes the disallowance on the grounds that its initial acquisition of L-49's and spare engines was at a spare engine ratio of 81%; that early difficulties with the engine dictated the need for additional spares which were acquired in such amount as to give a 100% spare ratio; that the subsequent higher spare engine ratios came about through loss or sale of six aircraft in the 1946-1948 period, and that the market for R-3350-BA engines was very limited. PAA witnesses testified that, although its 1947

[101] In terms of 14 aircraft the use of the 100% ratio allows ten more spare engines than would the 82% ratio.

spare engine ratio was between 117% and 140%, it had to cancel at least 40 scheduled Constellation flights in that year for lack of overhauled engines and made equipment substitutions on still others. Thus PAA submits that Bureau Counsel's proposal, based upon AOA's experience, is arbitrary and fails to meet the statutory standard which requires evaluation of PAA's efficiency on the basis of its own experience and problems.

On this issue PAA made a detailed "hindsight" analysis of its L-49 spare engine requirements based upon actual hours of use, time between overhauls (including failure removals), overhaul time, station spares and a "scheduling reserve."[102] That analysis indicated that the carrier was actually short of engines in the two peak quarters of 1947 and had the following spare engine requirements and indicated excess in later years:

	Required Spare Ratio (%)	Actual Spare Ratio (%)
1947	124	125
1948	109	149
1949	105	152
1950	91	139
1951	99	133

PAA submits that there should be no disallowance for excess engines because of its inability to find a resale market for these engines, but that if disallowance is made then it must be limited to the above-indicated excess spares.

Bureau Counsel rejects PAA's analysis on the basis that it rests upon "circular reasoning." In other words, a carrier having excess engines will, of course, distribute more at stations as spares than it otherwise would. It would accept a stretched-out overhaul time which would normally be considered inefficient and excessive. Thus to accept

[102] The "scheduling reserve" is an allowance to cover variations in need for overhauled engines because of "bunching" of engine changes.

PAA's actual performance as a measure of proper efficiency would only amount to a confirmation of an erroneous premise.

Upon consideration of all contentions it is concluded that the position of neither party presents a proper analysis. The comparative

13149

use of AOA's experience, particularly in the years 1947-1948, does not meet PAA's showing of its actual requirements based upon actual engine overhaul experience and the required overhaul time by the same outside firm that was performing AOA's engine overhauls. Detailed evidence as to AOA's engine failure experience, hours of use between time-limit removals, and schedule cancellations for lack of engines is not of record, but it can only be observed that its experience would necessarily have been substantially different from that of PAA to operate with an 82% spare engine ratio in 1947. Again, Bureau Counsel has taken PAA's analysis by quarters and averaged all four to arrive at an average annual excess. Where there is an annual peak season extending longer than a normal engine overhaul cycle such annual averaging is faulty. The spare engine requirements must be gauged by the peak season needs. On the other hand, Bureau Counsel's condemnation of the circular reasoning inherent in PAA's analysis is found to be valid for the years subsequent to 1947 when, by either party's approach, there were in fact excess engines.

It accordingly appears that a proper evaluation of PAA's excess engines should be based upon PAA's experience of record as to engine time, engine failures and time limit removals. Requirements for any year should be computed on the basis of the two peak quarters (2d and 3d). Station spares should be limited to a maximum of

13 through 1950, with two additional recognized thereafter to cover the additional AOA routes acquired. The engine overhaul cycle should be limited to a maximum of 50 days for main base removals and 75 days for other station removals commencing with the 3d quarter of 1948, when PAA began its own overhauls at Miami. And, finally, since this is a hindsight evaluation, and to allow a reasonable constructive period for disposition of engines thus appearing as excess, the disallowance should be limited to ½ of the amount computed for the first year in which a given excess number of engines appears.

PAA's actual assignment of engines as station spares in the 2d and 3d quarters of 1947 was 12. This number grew to 21, 18.5, 21.5 and 30 in the following years. AOA's assignment of station spares throughout the period was four. TWA's for the BD engine was four. Bureau Counsel's witness on this issue testified that PAA station spares might reasonably have reached a maximum of 13, and that level is believed reasonable with an increase of two to cover the AOA additional routes after 1950.

The engine overhaul cycle based upon the outside contractor's performance was 48 days in the second quarter of 1948, just before PAA began its own overhaul work at Miami. In the 3d quarter of 1948 PAA's own facilities required 75 days. In the last half of 1950 and for three quarters of 1951 PAA's overhaul cycle was 50 days or less. A 50-day overhaul cycle is somewhat higher than TWA's reported experience, and would appear to be a reasonable maximum to apply to PAA for main base (New York) removals. For removals at other stations additional transit time is, of course, required. PAA estimated this requirement for different periods between 38 and 58 days. The estimate was inadequately supported and is considered excessive; a

25-day average allowance is believed more reasonable. The other standards to be applied to a determination of the issue are clearly a matter of judgment and are believed to constitute a reasonable standard for this determination.

A computation based on the foregoing bases and standards should meet PAA's objections. It labels the specific points of inefficiency as (1) an overhaul cycle (in its own shop) in excess of 50 days, (2) station spares in excess of 13 (15) engines, and discounts its estimate of transit time for other than base station removals to the extent that the allowance exceeded an average of 25 days. The balance of the equation is PAA's own reported experience, with allowance of at least six months for a determination and disposition of the excess engines.

But while such a disposition of this issue is considered to be reasonable, a computation of the number of excess engines on this basis would result in a greater disallowance than Bureau Counsel has proposed. While it would indicate few, if any, excess engines for 1947, and fewer than Bureau Counsel's method for 1948, it would indicate a substantially higher number of excess engines for the remaining four years,[103] with a net increase of the expense disallowance of approximately $86,000.[104] * * * But it is clear that the use of Bureau Counsel of AOA's experience as a comparative base was unfavorable to PAA for 1947,

---

103 Excess engines under Bureau Counsel's proposal, and disallowed engines on the basis described, compare as follows:

	1947	1948	1949	1950	1951	1952
B.C. excess	17.0	27.5	29.0	24.6	23.9	28.0
Disallowed on other basis	—	18.0	36.9	38.8	42.0	44.2

104 Recognized investment would be higher than under Bureau Counsel's approach, giving an increased return element of about $3,000 on the basis of a 7% rate of return.

and possibly 1948, but thereafter gave PAA substantial benefit.

With respect to PAA's contention that these spare engines were not saleable, the record is inadequate to support such a finding. PAA testimony on the point was general, to the effect that known users of the engine and brokers were "circularized" in 1950, but the asking price was not furnished. Such sales as have been made were all at prices above book value. Had PAA made a reasonable disposition of excess engines at a loss that loss would herein be recognized. In the absence of supporting evidence it cannot be assumed that in the future rate period the carrier will incur a loss on their sale.

Incorporated in the disallowance proposed by Bureau Counsel are offsets totaling $23,700 representing profit on sale of certain spare engines and rental income therefrom in the years 1950-1951. PAA submits that there should be further offsets to eliminate the entire

13151

disallowance because of (1) accident insurance recoveries which resulted in disposition gains totaling $791,000, and recorded retirement gains attributable to engines sold along with aircraft totaling $196,000 in this period. But the two additional offsets cannot be recognized. The Board supports with mail pay the practice of insuring equipment at market, rather than book, value. In the long run insurance payments will exceed insurance recoveries, hence any excess of short term gains must properly be applied as all other revenue to reduce a carrier's need during a period under review. There is no sound reason for its application to offset an inefficiently incurred expense. With respect to the gains over book value realized from the sale of engines on aircraft, this merely indicates that for the particular sales involved the recorded

depreciation was excessive. The profit realized is applied as all other revenue to reduce need and thus correct the erroneous prior depreciation charges for those aircraft and engines. The only proper question raised by such sales is whether the established depreciation charges for similar aircraft is an overstated expense on the carrier's books. That issue is not directly presented herein. To the extent that it is indirectly raised by Bureau Counsel's proposal to increase residual values to 15% it is found to be supported by the available evidence. In any event there is no basis for offsetting the book profit on the sale of this equipment, which has been recognized as used and useful, against the disallowance of recorded depreciation expense for excess spare engines.

In accordance with the foregoing it is concluded that PAA retained excess R-3350-BA engines in the review period, totaling not less than those proposed for disallowance by Bureau Counsel, and that recorded depreciation of and investment in such engines cannot be recognized for mail rate purposes.

All Cargo Service:

In the earlier discussion of the all cargo service issue with respect to TWA it was held that experimental service not exceeding one weekly round trip should be underwritten with mail pay through April, 1949; that the "added cost" approach to computation of expenses attributable to such service was generally proper; that a standard of profitability had been adopted and made known by the Board as a matter of policy in April, 1949; that such standard is a reasonable measure of efficient management and should be applied for all subsequent periods in this proceeding; that revenues from carriage of foreign mail

should be given full credit in assessing the profitability of the operation, and that U. S. mail carried should be given only an indirect credit based on constructive displacement of commercial traffic on other flights as proposed by Bureau Counsel.

In the case of PAA there would still result a substantial disallowance for the years 1948-1950 and 1952, approximately $380,000, when those holdings are applied to modify Bureau Counsel's position. It is accordingly necessary to consider other matters urged by PAA which would further modify the result.

13152

The revenue credit allowed by Bureau Counsel for comat which moved on the all cargo flights is based upon 10 cents a ton-mile (approximate surface rate) for all engines carried, plus an allowance at air cargo rates for movement of engines beyond the European rateways and a 10 cents per ton-mile credit for 50% of all other comat. PAA takes issue with this approach as it relates to the engines carried and submits that the credit should recognize a need for not less than 50% of the total engine movements by air at the air cargo rate, which would reduce the remaining disallowance by about $86,000.

Engines, of course, could not be shipped on the combination aircraft. They had to move either via boat or all-cargo aircraft. From a comparison of the number of engines moved by all-cargo flights with the number of foreign station engine removals for the L-49 engines, it appears that PAA in fact moved essentially all of its engines to and from foreign stations by air.

Bureau Counsel's allowance for engine movement takes the position, in effect, that there was an adequate number of overseas spare engines so that emergency needs could

be met by flying existing station spares to the points where needed. Hence there would be no need for transatlantic movement by air. The resolution of these different contentions falls in a judgment area. Bureau Counsel's position has certain deficiencies. It fails to concede that any transatlantic engine movement might be critically concerned with the time factor. It makes no allowance for the fact that the surface pipeline requirement would in effect reduce the available station spares and that this, in turn, would call for additional air carriage between foreign stations. Considering all such factors it is believed, and so found, that the comat credit proposed by PAA is reasonable.

Differences with respect to proper costing of sales expenses for the all-cargo operation represent approximately $60,000. Bureau Counsel has employed a basic ratio of 7.5% of freight revenues to derive the dollar amounts. PAA submits that a 5.0% ratio is proper. Bureau Counsel notes that the sales commission paid to cargo agents is 5%, and that in addition there are additional commissions paid to general agents. He supports his 7.5% ratio further on the basis that it must also cover administrative cost, overhead in the sales department, and salary and travel expense of company employees who sell cargo service. PAA, on the other hand, points out that only a part of the cargo traffic is sold by agents, that a TWA analysis showed that its total commission payments to cargo agents were only 2.0% of cargo revenues. PAA submits that its 5.0% ratio is therefore adequate to cover the additional items that Bureau Counsel has named. Considering the fact that the all-cargo service here in issue has carried less than 25% of PAA's total cargo business in each of the years concerned it is concluded that

the 5% ratio proposed by PAA is adequate to cover the added expenses in this category.[105]

13153

PAA and Bureau Counsel have one further difference relating to revenues which PAA contends will support a reduction of the disallowance in the amount of $29,000 for the year 1952. The computation of commercial revenues attributable to the all-cargo service has been based on ton-miles moved on such flights and average cargo yield for the entire Atlantic Division. Because the all-cargo flights operated essentially to European gateway points, between which tariff rates average somewhat higher than for the beyond gateway carriage, Bureau Counsel and PAA came to an agreement on an increased yield to be used for the all-cargo service. Subsequently, based upon 1952 results as they became available Bureau Counsel proposed a still higher cargo yield for purposes of forecasting 1953 results. PAA contends that Bureau Counsel's 1953 forecast should also be applied to 1952. But the adjustment is not believed proper. The all-cargo service is of value largely because it can accommodate larger packages than can be handled on the combination aircraft. The carrier's tariffs give rate reductions as the weight of a shipment increase. While the parties may have made some analysis bearing on this question in reaching their earlier agreement, it was not made of record and in the absence of affirmative evidence it cannot be found that PAA's contention is properly supported. The proposed increase of Bureau Counsel in the 1953 forecast may have resulted from tariff increases relating to a traffic growth in the small shipment category which would tend to move principally by com-

105 The decision to underwrite the all-cargo experiment through April, 1949, makes it unnecessary to decide an issue involving $10,000 for cargo handling expense in the years 1947-1948.

bination aircraft. Accordingly the PAA contention will be denied for lack of supporting evidence.

Finally, PAA submits that it should be allowed to offset any remaining loss on the all-cargo service by profits which have resulted from charter service in the amount of $283,000. PAA characterizes Bureau Counsel's opposition to such offset as a "heads-I-win, tails-you-lose" approach. Or spelled out, if the carrier operates these services at a profit it is applied to reduce need, if at a loss the carrier bears the loss. While the characterization has a surface appeal it lacks substantial merit. The mail pay assistance to be given under the Act is to need incurred under standards of economical and efficient management. If charter revenues do not support the added expense of the service then *prima facie* the charter tariff rate is too low. The standard herein applied to the all cargo service is one of profitability on an added cost basis, which is a lower standard than is applied to the principal service of the carrier, the passenger carrying service. That lower standard is clearly a competitive advantage to the persons, property and mail carrier and should not be made more so by any offset of charter profits.

In accordance with the foregoing the all cargo operations of PAA in the years 1948-1952 are found to have failed to meet the prescribed standard requiring the disallowance of claimed mail pay * * *.

Selling Expense:

The earlier discussions of this issue as it related to AOA and TWA require the conclusion that PAA, the operator of the greatest volume of transatlantic service with B-377 aircraft, must be held to

the 19.5 selling expense ratio proposed by Bureau Counsel. As computed by Bureau Counsel the resultant PAA disallowance is $2,034,657.[106] PAA contends that its selling expenditures were reasonable and should be recognized.

Much of the force of PAA's argument in support of its selling expenditures is directed at the unreliability of TWA's reported data. PAA notes that reported figures show that TWA had the highest selling expense ratio of the domestic big four during the years in issue, notably prior to 1951, and in the same years showed a lower international ratio than PAA and AOA.[107] PAA submits that this does not make good sense and that it is obvious that in the substantial areas of selling expenses which require allocation between domestic and international, TWA has overcharged domestic and undercharged international. PAA made a reallocation for TWA as between domestic and international to show that with a reduced domestic selling expense ratio, but still above the big four (less TWA) average, TWA's international selling expense ratios would be higher than those of PAA except for 1949 when PAA would be one-tenth of a percentage point higher. It must be noted that this reallocation made by PAA was without benefit of access to TWA's detailed accounts. Bureau Counsel's witness testified that Board auditors had reviewed the TWA records and had noted no significant exception to the method of recording or assigning these selling expenses. Considering the finding made earlier, that the level of the selling expense ratio is

106 The proposed disallowance by years is as follows:

1949	1950	1951	1952	Total
$104,852	$607,329	$482,476	$840,000	$2,034,657

107 Ratios are set forth on page 38.

very substantially within the control of management, it is quite possible that management decisions created the TWA difference which to PAA "does not make good sense." The lag of TWA behind its domestic competitors in replacing the DC-3 in the post-war period might reasonably have called for increased selling expenditures in that division. In any event, it cannot be found that PAA has adequately supported its proposed reallocation. Even if it were so found, it would not be accepted as a proper comparative base for evaluating PAA expenditures because of the substantial competitive advantage of the B-377 in the configuration operated by PAA. For the reasons set forth previously with respect to AOA it is held that the 19.5% level is a proper maximum for PAA's selling expense ratio.

There are certain differences between PAA and Bureau Counsel as to the proper derivation of PAA's selling expenses for use in computing the disallowance. First, PAA submits that its reported selling expenses for 1950 included $396,000 representing abnormal expense associated with the AOA merger and which would normally be deferred and amortized over a period of years. Bureau Counsel would defer only $200,000, noting that such amount was added to the normal PAA plus AOA advertising and publicity budgets at the time of the merger

13155

by transfer from PAA's Latin American Division.[108]

PAA derived its figure of $396,000 by taking the average ratio of advertising and publicity expenses to transport revenue for the last quarters of 1949 and 1951 and applied

[108] There is no dispute that at the date of merger AOA's unexpended 1950 budget for advertising and publicity was $248,000, and that PAA by transfer from LAD added $200,000. The issue concerns how much of the total of $448,000 should be considered normal expenditure, and how much abnormal expenditure to publicize the merger and preinaugural advertising for the new points Paris and Rome.

it to 1950 revenues to construct a "normal" expenditure for 1950. The excess of $396,000 was thus labeled abnormal. While the approach is not irrational it is believed to indicate an unreasonably low "normal" expense of $52,000 for the AOA services taken over by PAA. It can be recognized that the AOA acquisition eliminated a need for duplicate "normal" advertising and publicity expense at the major points which had previously been directly served by both carriers, U. S. terminals, Shannon, London and Frankfurt. But to attribute 80% of AOA's normal advertising and publicity expenditures to these points, out of a total of 16 served, appears excessive. On the other hand, Bureau Counsel's failure to make any adjustment of the normal AOA amount budgeted, to reflect the savings at points common to both systems, is unreasonable. The determination of the proper point between the positions of the parties is a matter of judgment. On the basis of the available evidence it is found that not less than 50% of the amount budgeted by AOA for the 4th quarter of 1950 should be treated as expended by PAA for "normal" advertising and publicity purposes. The amount to be treated as "abnormal" expense, and thus exempt from the selling expense disallowance is accordingly $324,000.

PAA has identified $262,000 spent in 1952 for advertising the inauguration of DC-6B tourist service prior to the first such flight in May of that year. PAA apparently reported such expense as incurred in the early months of the year (1st and 2d quarters) but in filing its reports for the fourth quarter eliminated a corresponding amount for deferral less $26,000 for 1952 amortization. PAA submits that such deferral of this abnormal expense, which it likens to a pre-operating or integration expense, is proper. Bureau Counsel opposes the adjustment on the ground that it does not appear that these advertising

expenditures constituted an abnormal item. Bureau Counsel's conclusion rests upon the following comparison of PAA advertising and publicity expenses, by quarters, for the years 1951 and 1952:

	1951		1952		
	Amount	% of Annual	Amount	Reported	Reversing Deferral
1st Q	$ 559,708	21.2	$ 696,846	21.8	20.3
2d Q	756,137	28.7	877,939	27.5	25.6
3d Q	609,944	23.2	813,263	25.5	23.7
4th Q	708,419	26.9	803,505	25.2	30.3
Year	$2,634,208	100.0	$3,191,553	100.0	100.0

13156

Bureau Counsel submits that the close comparison of % of annual expenditures for the first two quarters of 1951 and 1952 (reported) negatives PAA's contention that there were abnormal expenditures to herald the coming of tourist service in the first four months of 1952. Bureau Counsel consequently would refuse recognition of the 4th quarter bulge of $262,000 either as expense in that quarter or for deferral.

On the basis of the available evidence the position of Bureau Counsel must be sustained. It is noted that if there were subtracted from the reported expenditures for the first two quarters of 1952 the $262,000 which PAA claims as abnormal relating to the forthcoming tourist service, then the advertising and publicity expenditures for the 1st half of 1952 would have been below the amount spent in the comparable part of 1951. On the other hand, the expense apparently incurred by PAA in these accounts in the last quarter of 1952, which would have been reported except for the deferral, is substantially out of line

with earlier experience and reasonable justification and has not been explained by PAA * * *.

Undercollections:

For the reasons set forth earlier in treating this issue with respect to AOA[111] it is found that PAA undercollections totaling $135,000 for the past period were the result of inefficient management and cannot be recognized as a valid claim.

U. S. Head Tax; Portuguese Portella Tax:

Bureau Counsel has proposed to disallow a total of $35,000 paid by PAA in 1947 and 1948 for special taxes which were the legal obligation of passengers. The U. S. head tax of 8 dollars per person was levied upon aliens entering the United States. While of general applicability there were many exceptions provided. In the event an alien could not pay the tax the expense of his detention or return to point of origin was required to be borne by the carrier. PAA made no attempt to collect the tax, or ascertain the ability of the alien traveler to pay it, in advance.[112] It submits that the same practice was followed by other air carriers and that it was obviously reasonable for the carrier to pay the tax for indigent aliens rather than to bear the expense of their detention or return.

The position of PAA cannot be upheld. The carrier was fully aware of the tax requirement and of its responsibility in the event it transported an alien who could not pay

111 See page 32.

112 Bureau Counsel presented in evidence a letter from United States Lines, establishing that their practice was to collect the head tax before issuing a ticket.

the tax. The frequency of the occurrence, over two a day in 1947, and slightly less than that in 1948, was clearly such as to require management action. The carrier's 8 dollar gift[113] to such passengers would appear to be a

13157

rebate in violation of section 403 of the Act. Had PAA made reasonable effort to collect the tax in advance, or assure itself of the ability of the alien to pay it, it is obvious that the amount in issue would have been essentially eliminated. It is clear that the carrier's inefficiency gave rise to this portion of its mail pay claim and it cannot be recognized.

The Portuguese Portella tax was a Government levy on passengers embarking or disembarking at a port in that country. Varying according to the value of the traveler's ticket it ranged from $1.00 to $9.60 per passenger. Essentially similar facts and the same considerations apply here as for the U. S. head tax. PAA has indicated that the Portuguese application of the tax law was strict and required certain payments by PAA for passengers who were not scheduled for Lisbon but had to leave and return to the airport on flights which were interrupted. PAA has not identified the part of the $23,000 here in issue which would relate to such interrupted trips. If it had, that part would be recognized. But it is found that proper accounting would have segregated such payments from those not related to an interrupted trip. On the basis of the available evidence it cannot be found that the $23,000 includes amounts related to interrupted trips. Accordingly the entire amount must be disallowed for mail pay purposes.

---

113 PAA testimony indicated some collection effort was made, but that it was generally ineffective.

Aircraft Project Expense:

Bureau Counsel proposes to disallow expense totaling $16,000 incurred as cancellation expense on three separate contracts. The first ($4,000) relates to a 1945 contract for a post-war version of the XC-99, a large military cargo transport. Inability of Convair to meet the contract specifications gave PAA the right to cancel, which it did. The second ($9,000) related to a 1944 contract for a large transocean aircraft known as the L-89. PAA and Lockheed had initiated development of this plane in 1942 which was later taken over by the Navy. Two such aircraft, known generally as the Lockheed Constitution, were delivered to the Navy. Inability of Lockheed to produce the aircraft in the post-war period at the tentative contract price gave PAA the option to cancel upon assumption of the indicated termination charge. The third contract ($3,000) related to multi-channel radio transmitters. Recognizing a need for such equipment, and finding none in commercial production, PAA contracted with PAMSCO, a subsidiary which it organized,[114] for their production in 1946. After partial completion of the contract PAA found that it could then obtain superior transmitter-receiver units from another firm at a substantial cost saving. It accordingly terminated the PAMSCO contract.

Bureau Counsel's proposed disallowance is based on different grounds for the aircraft projects and the radio transmitters. As to the two aircraft projects Bureau Counsel submits that they made no material contribution to PAA's operations during the review period. Bureau Counsel contends that these expenses are similar to expenses for route extension and development, as to which

---

114 PAA divested itself of its interest in this company in 1946. The record does not establish whether that divestiture was before or after placing the contract in question.

Board policy recognizes only those which contribute materially and directly to the services

13158

for which mail pay is to be provided.[115] Bureau Counsel notes a precedent in the Board decision denying Wiggins Airways' mail pay claim for expenses incurred in contemplation of DC-3 operation which never materialized.[116] PAA submits that the developmental purposes of the Act require study and consideration by air carriers of advanced equipment types and that these designs at the time the contracts were made gave reasonable promise of being desirable post-war equipment.

It can be conceded that the developmental purposes of the Act require air carrier management to study and consider the acquisition of new and improved aircraft. No doubt some part of the time of technical and top level management personnel of all air carriers is devoted to this question. No case can be found in which the Board has endeavored to allocate the expense incident to such activity or review the propriety thereof for mail rate purposes. The *Wiggins Case* cited by Bureau Counsel is not squarely concerned with such activity since the DC-3 was not at the time in the category of a new or improved aircraft. Its operating characteristics and costs were already well established. On the other hand, the issue here presented with respect to PAA does not relate to PAA's unidentified company costs for study and consideration of new and improved aircraft. The issue relates to specific contract cancellation charges. Thus, on the basis of past decisions indicating that the Board does not question normal activ-

---

115 *Frontier Airlines, Inc., Mail Rates*, Order No. E-6341, April 21, 1952; *Colonial Airlines, Inc., Domestic System Mail Rates*, Order No. E-5777, October 9, 1951.

116 *E. W. Wiggins Airways, Inc., Mail Rates*, Order No. E-5886, November 23, 1951.

ity by carrier personnel in studying and evaluating new and improved aircraft, the question presented is whether the fact of contract cancellation shall be held to establish that the execution of the contract was so unreasonable or premature as to require disallowance of any cancellation expense incident thereto. In other words, should the Board as a matter of policy draw the line for mail pay purposes between company expense for study and evaluation on the one hand and cancellation expense for unfruitful contracts on the other.

It is found that there are reasonable grounds for distinguishing at that point and that the position of Bureau Counsel should be adopted. Contracts for aircraft are normally filled in the order of execution of the contracts. A carrier who first acquires a new and improved aircraft will thereby obtain some advantage over its competitors. It should also be noted that there is usually some publicity of value to the carrier which follows the execution of a contract for new aircraft, particularly to the first carrier contracting for the new model. Thus, if the Board were to underwrite contract cancellation expense it would serve the interests of each carrier to be the first to contract for a proposed new aircraft which might represent an improvement over existing models. Such a policy could obviously expose the Board to substantial mail pay claims for contract cancellation.

On the other hand it must be recognized that any post-cancellation evaluation of the reasonableness of contracting for a given proposed

aircraft as of the time of the contract involves many highly technical factors. The evidence of record herein is grossly inadequate for any such evaluation. In the light of all such considerations it is found that a policy

which denies contract cancellation expense for unfruitful contracts for new or improved aircraft does draw a reasonable line between premature commitment and the efficient and economical management requirements of section 406.

Bureau Counsel's objection to the PAMSCO contract is that the carrier has failed to demonstrate that its actions were reasonable. The essential point urged is that PAA entered into the PAMSCO contract upon a determination that the desired transmitter was not commercially available, but failed to make reasonable inquiry of known manufacturers of aircraft radio equipment to determine whether such equipment was being designed and developed for production.

On the basis of the evidence of record it cannot be found that PAA's actions were unreasonable in ordering initially, or subsequently cancelling in part, the PAMSCO transmitter contract. PAA had on order in 1946 a new fleet of Boeing aircraft. It foresaw a need (not disputed) for improved radio equipment for those aircraft which was not in existence. It should be noted that delivery of the Boeings was, in early 1946, estimated at early 1947. The placing of the PAMSCO contract in 1946 thus appears reasonably related in time to the need for the equipment in early 1947. PAA learned of the existence of the improved transmitter-receiver from a different source in "late 1946 or early 1947." It was not until September, 1947 that it cancelled, in part, its PAMSCO order and contracted for the other improved equipment. It received delivery of the PAMSCO units for its B-377 fleet. They were installed and, though subsequently modified, are in use today.

As to Bureau Counsel's contention that PAA should have made a better check into transmitter equipment then in process of design or development by known radio manufacturers it would appear that PAA, a major operator

of long-range aircraft, might reasonably assume that equipment manufacturers would make known their intended new products at such time as the manufacturer determined to produce them and to make known that decision. On the facts of record it appears that there was a lag of a substantial part of a year between the time when PAA had to order the equipment in question to meet the then expected aircraft delivery schedule and the time when other improved equipment was established to be available. The subsequent delays in aircraft delivery would have tolerated such delay in ordering the radio equipment, but the later occurrences cannot change the propriety of an action which was reasonable under existing circumstances at the time taken. It is accordingly concluded that the PAMSCO contract cancellation charge was incurred by PAA in the exercise of honest, economical and efficient management and should not be disallowed.

Settlement of Law Suits:

Bureau Counsel proposes to disallow $9,812 paid by PAA in 1948 to two former employees, representing amounts paid by the carrier in settlement of their actions on claims of breach of employment contracts.

13160

Each employee, after some domestic employment with PAA, was given an overseas assignment. PAA submits that there was no commitment as to the duration of such assignment or continued employment, but the action relied upon PAA travel orders which, "following the then current practice, stated that the duration of the assignment would be approximately three years." Their employment was ended after less than three years overseas and the settlement amounts represent essentially a lost salary claim. The amounts claimed in the suits were substantially larger.

PAA submits that such suits are a normal business occurrence and that the settlements were sound and prudent. But the soundness of the settlement once the action was brought does not establish that the carrier's actions which gave rise to the suits were a proper discharge of its responsibilities. A written agreement relative to the overseas assignment could have avoided the employee actions. To recognize the settlement amounts would underwrite employee compensation, where no services were rendered. This is not in accord with the mail pay standards of the Act. PAA has attempted no showing that the termination of the two employees concerned improved its efficiency in any way to offset the settlement amount. In the absence of such an effort it must be held that the settlement expense cannot be recognized for mail rate purposes.

Salaries and Expenses of Officials:

Bureau Counsel has questioned the propriety of underwriting with mail pay the salaries and expenses of two PAA Assistant Vice Presidents, Messrs. Cone and McEvoy, who are assigned to the carrier's Washington office. The issue covers all years under review, 1946-1952, and the proposed disallowance totals $259,000, of which $119,000 is allocable to PAA's Latin American Division but considered herein by agreement of the parties. PAA has charged the salaries and expenses in issue to the public relations function of its general and administrative account.

Bureau Counsel contends that PAA has failed to support the reasonableness of the promotional or advertising expense represented by these salaries and expenses. PAA has agreed to the disallowance of 50% of the amount in issue and has presented a written summary of the work performed by the two officers covering not less than 50% of their time, for which PAA claims mail compensation. The individuals concerned were not called as witnesses.

As Bureau Counsel submits, the evidence presented by PAA covers the activities of these officers in rather general terms. It affords no basis for any time allocation of their efforts between various types of work. Thus, as to both, PAA submits that some part of their time was spent in calling upon Government transportation officers and other officials to obtain increased Government traffic for PAA, which efforts were highly successful. Such activity would appear to be properly chargeable to the "selling expense" accounts. A prior issue would have disallowed any additional charges to selling expense for 1949 and subsequent years. Arranging trips for high Government officials and Congressional committees, and accompanying many such trips,

13161

appears to represent special service over and above that which should be recognized as a normal responsibility of a certificated carrier. Efforts devoted to relieving the carrier from actual and potential fines under the Immigration Act cannot be recognized since the Board obviously could not hold a carrier reimbursable for fines imposed for violating the laws of the United States.

Certain of the activities described can be generally recognized as being, in part, reasonable and necessary efforts in the fields of administration, selling, or public relations. But in view of the inadequacy of the carrier's evidence to permit a reasonable appraisal of the relative extent of such effort, plus the findings that several areas of activity claimed as reimbursable by the carrier cannot be so held under the standards of the Act, it is concluded that the total amount in issue must be disallowed for mail pay purposes.

• • • •

(13161)

Excess Need:

Bureau Counsel has maintained the position throughout this proceeding that in addition to the foregoing specific adjustments of PAA's mail pay claim he would also propose a broad disallowance of any remaining PAA need which was in excess of the adjusted need of TWA, which is attributable to PAA operations over segments comparable to those served by TWA, and which was not explained and justified by PAA. Based upon Bureau Counsel's position on all other issues he has computed that PAA's operating break-even need totaling $17,477,000 is in excess of what PAA's need would be over the Transatlantic-Europe-Asia sector for the 1948-1952 period if PAA were held to the break-even need per revenue ton-mile recommended for TWA. Of that amount, Bureau Counsel takes the position that PAA has made an adequate explanation of the excess in part, but that the carrier's attempted justification of the remainder, $7,439,000, is not acceptable and that amount must be disallowed.[125]

As was noted earlier,[126] there is no true issue of a "uniform rate" in this proceeding. Though PAA objects to this proposed comparison on the limited "comparable segments" as an unlawful attempt to substitute a uniform rate for the statutory requirement which calls for the consideration of "the need of each . . . carrier", its position is clearly untenable. The remaining areas of difference between PAA and TWA have been reasonably identified and each will be considered.

While no party hereto contends for the establishment of a true "uniform rate", TWA has urged that there should

---

125 Rulings on the specific issues have not incorporated Bureau Counsel's position on all issues and accordingly the amounts herein discussed are subject to adjustment. However, the principles are the same and the discussion will employ figures based upon Bureau Counsel's position on brief.

126 pp. 8-10.

be a basic uniformity, i.e., that different needs between the carriers should be recognized only to the extent that they are identified as related to some part of one carrier's operation which is not comparable to that of the other.

13162

TWA generally submits that the two existing transatlantic carriers have been, throughout the review period, more comparable than the domestic big four carriers on the basis of the parameters set forth by the Board in setting their uniform mail rate. The comparison presented by TWA follows and affords a general comparative orientation of value for the ensuing discussion.

	TWA-Pan American Average 1946-1951		Ratio Largest to Smallest	
	Largest	Smallest	TWA-PAA	Big Four (Order E-5560)
Size and Volume Factors				
Total Revenue Ton-Miles (000)	45,389	37,327	1.22 P*	1.62
Average Daily Route Miles in Operation	17,505	11,293	1.55 P	1.36
Density and Plant Utilization Factors				
Revenue Ton-Miles Per Route Mile Per Day	8.95	6.87	1.30 T	1.49
Revenue Ton-Miles Per Station Per Day	4,944	4,764	1.04 P	1.80
Average Daily One-Way Trips	2.63	1.90	1.38 T	1.19
Route Miles Per Station	746.6	537.4	1.39 P	1.25
Passenger Load Factor (%)	63.50	61.32	1.04 P	1.13
Operational Factors				
Average Length of Passenger Trip (miles)	3,121.1	2,168.4	1.44 T	1.51
Average Length of Hop (miles)	957.5	834.1	1.15 T	1.50
Performance Factor (%)	96.35	94.51	1.02 T	1.02
Passenger Revenue Yield Per Passenger Mile (cents)	8.999	8.518	1.06 T	1.02
Mail Volume and Density Characteristics				
U. S. Mail Ton-Miles (000)	2,879	2,854	1.01 P	2.48
Percent U. S. Mail to Total Revenue Ton-Miles	7.84	5.90	1.33 T	1.85
U. S. Mail Ton-Miles Per Route Mile Per Day	0.68	0.42	1.62 T	2.13
Average U. S. Mail Load Per Plane Mile in U. S. Mail Service (lbs.)	557.1	463.9	1.20 T	2.43
Average Relationship of Largest to Smallest			1.25	1.59

* Larger carrier in each ratio: P-PAA, T-TWA.

The foregoing comparative data for PAA and TWA embraces their entire operations for which rates will be set in this proceeding. Because of incomplete breakdowns of reported data by segments similar comparisons between TWA and PAA's Transatlantic-Europe-Asia sector would necessarily rely in part on estimates and allocations. It is clear, however, that if PAA's services to South Africa, Bermuda, the AOA Scandinavian points and its internal German services were eliminated the ratios would be closer. The Annual Revenue Ton-mile ratio would change from 1.22 (P) to approximately 1.06 (T). The figure for Revenue Ton-Miles per Station has been given special significance by its use in the Board's Administrative Separation of Subsidy Mail Pay as a basic parameter for grouping carriers. PAA has objected to the TWA computation of this ratio on the ground that, for TWA, it credits as full stations the TWA domestic stations such as Washington, Philadelphia, Chicago, Detroit and Boston which allocate to TWA-International only a relatively small part of the total station costs. The validity of the objection can be recognized. But if these TWA domestic stations be counted only in such part as the allocated cost compares to the cost of foreign stations producing a like volume of traffic, and if the ratio be based on PAA's comparable segment, the ratio still is closer. TWA's exhibit, in the detail by years, showed the TWA advantage in this comparison to be greatest in 1950—1.28. The ratio for that year, revised as indicated above, becomes 1.14. For the three years 1948-1951 TWA's exhibit gave an average ratio of 1.18; the revised computation would reduce it to 1.10. On this point it is noted that this ratio as between the top two of the big four domestic carriers was 1.25.

The foregoing is believed to support the contention of

TWA that there exists a sound basis for broad comparisons as between TWA-International and PAA-Atlantic. The general comparability is clearly adequate to support Bureau Counsel's position that the high need carrier must assume the burden of identifying and justifying those aspects of its operation which give rise to its higher need.

In arriving at the figure of $17,477,000 as the apparent PAA excess need to be justified, Bureau Counsel has followed his position on all other issues with two exceptions. The first is that, though resisted for policy reasons, all of TWA's requested domestic-international reallocations which would otherwise be considered meritorious have been allowed for purposes of this comparison. Secondly, amortization of TWA deferrals for items other than L-49 grounding, L-749 training, crew, training expense, and move of overhaul base to, and from New Castle have been eliminated. The eliminated deferrals are essentially related to extension and development and preoperating expenses and total approximately $3,685,000 for the review period ($1,995,000 for 1948-1952). Bureau Counsel's 17 million dollar figure incorporates one offset claimed by PAA for its relatively low level of foreign mail revenues in the amount of $1,172,000. A further allowance of $10,225,000 is deemed justified by Bureau Counsel as representing the higher operating costs of PAA's B-377 and L-49 aircraft. All other matters urged by PAA in justification of the remaining $7,439,000 of excess need are rejected by Bureau Counsel.

13164

PAA, on brief, differs with Bureau Counsel on numerous items involved in the comparison, indicating that the excess need to be explained is 6.2 million rather than Bureau Counsel's 17.4, and identifying areas of difference aggregating 20.7 million in which PAA submits that its

higher need is justified. Thus PAA contends that its apparent excess need is fully supported and shows that its operations have been more efficient than TWA's to the extent that they are comparable.

It is not necessary to define with precision the area of excess need with which this issue is concerned, whether it is 18.6[127] million as indicated by Bureau Counsel, 6.2 million as presented by PAA, or some other amount. The difference of 12.4 million between these figures represents essential differences on three major points: (1) whether the comparison should include all years or only from 1948 through 1952 (2.7 million); (2) whether additional adjustments should be made to TWA's need for purposes of this comparison (5.5 million), and (3) the proper computation of need for PAA's other segments (3.9 million).[128]

On the first point, whether PAA's lower unit need for 1946-1947 should be allowed to offset its higher need in the subsequent years, it is concluded that it should not. It cannot be found that there is any interrelation between these periods which would relate the lower unit need of the earlier years to the areas of excess need in 1948 and subsequent years. The higher PAA need in the later years is reasonably accounted for by three factors: (1) higher direct operating expenses, (2) lower foreign mail volume, and (3) a lower yield per unit of other commercial traffic. The first of these factors did not exist in the earlier years. The last two were present to some extent, but did not result in a break-even need for PAA above that of TWA. Since the approach here urged is directed initially to a determination of the areas creating excess need it appears

---

127 The 18.6 million figure combines Bureau Counsel's 17.4 million indicated excess need and his proposed 1.2 million foreign mail allowance.

128 Other lesser differences reflect discrepancies between Bureau Counsel's position on brief and PAA's estimate of what that position would be.

proper to eliminate consideration of the 1946-1947 period as an offset for the results of the later period.

Differences between PAA and Bureau Counsel as to the 1948-1952 TWA break-even need to be used for comparative purposes are in part due to changes of Bureau Counsel position on brief and the exclusion by Bureau Counsel of amortization of preoperating and extension and development expenses. The exclusion of TWA's deferred preoperating and extension and development expense is found proper for purposes of this comparison for the obvious reason that PAA has no comparable expense. In fact, it appears that the approach used by Bureau Counsel with respect to non-operating items is liberal for comparative evaluation. It gives PAA a constructive allowance for such items which is in excess of PAA's indicated need in this category and for this period by more than 1 million

13165

dollars ($1,071,000), even after reversal of Bureau Counsel's contention with respect to "non-divisional" investments.

PAA proposes an additional group of adjustments to TWA's need for purposes of the present comparison which have a common premise, i.e., TWA's domestic-international expense allocations were faulty even beyond the amounts proposed for reallocation by TWA. PAA would reallocate an additional $2,309,000 to TWA-International for the years 1948-1950. About 90% of these further reallocations relate to TWA "selling expense" in those years. As was previously noted, PAA's approach to these reallocations is very broad, resting essentially upon the observation that the reported split doesn't make good sense. The contention cannot be accepted. The other 10% of this group would reallocate additional amounts to TWA-International for executive staff expense and

legal expense on the basis that TWA's proposed reallocations for 1951 for the former and for 1950 and 1951 for the latter should be extended to the prior years. PAA's approach here was to assume that the reallocation should be ½ of the TWA proposal for the years 1946-1948 and the full amount for later years. TWA's witness stated that there might be some basis for reallocation in these earlier years, but that no studies had been made to establish the need or proper basis therefor. PAA has noted on brief that ". . . major changes in methods of allocation were made by TWA every year and sometimes twice a year." It must be recognized that in attempting to identify the area of excess PAA need there is a portion of some consequence which hinges upon expense allocations of both carriers rather than upon direct assignment of expense. But not all allocations work against PAA. TWA allocates certain expenses between domestic and international divisions. PAA allocates similar expenses between its Atlantic and Latin American divisions and to some extent to its Pacific and Alaska divisions. Both carriers split the expense of their major U. S. terminal, New York, between divisions. In segmenting PAA's Atlantic division for purposes of this issue it receives a further split of New York expense as between the transatlantic and Bermuda services. PAA derives the benefit of similar segment allocations at Shannon and London when the Scandinavian segment is split off, at Frankfurt when the internal German operation is segregated and at Lisbon with respect to the South African segment. The dollar benefits flowing from such expense allocations cannot be precisely measured, but there appears no basis for assuming or concluding that PAA is in a position less favorable than that of TWA. It is accordingly found that the additional TWA expense reallocations proposed by PAA for purposes of this issue are not warranted.

PAA's remaining proposed adjustment of TWA need for the present comparison relates to TWA's ability to operate New York-Kansas City maintenance flights of international division aircraft as revenue flights on its domestic routes. PAA computes the TWA benefit from this arrangement as $525,000 for the 1949-1952 period. The request for addition of this amount for comparative purposes implies, of course, that PAA had no comparable opportunity on its New York-Miami maintenance flights. As was noted in the issue relating to PAA's maintenance ferry flights, that carrier was able to charter a substantial number of such flights to domestic carriers in recent years. There was no showing made that similar opportunity was absent in the earlier years. While it may be accepted that the inter-divisional arrangements made by TWA would be

13166

somewhat easier to accomplish than the inter-company charters for PAA, any allowance for this factor could be but a small part of the amount contended for by PAA. In the light of the previously noted 1 million dollar benefit to PAA flowing from Bureau Counsel's treatment of non-operating items the maintenance flight offset is not of such significance as to warrant individual adjustment.

• • • •

There is general agreement between Bureau Counsel and PAA that the higher operating costs of PAA's B-377's and L-49's, as compared to TWA's L-749's account for approximately 14.6 million dollars of PAA's higher need for the years 1948-1952. While there are some differences as to the amount attributable to each aircraft type it is found that Bureau Counsel's appraisal is more complete. It indicates that 11.4 million applies to the B-377 and 3.2 million to the L-49. Both parties agree that the total

indicated higher cost is a gross figure and that an offset should be made to reflect the higher average load factors realized on the B-377. Bureau Counsel has computed such credit as 4.5 million dollars. PAA arbitrarily reduced its computed 12.9 million excess for the B-377 by 50% to reflect this factor. The analysis made by Bureau Counsel is found to be a more reasonable approach than PAA's arbitrary reduction.

• • • •

As was previously noted, Bureau Counsel has accepted PAA's evidence covering the selection of the B-377 as establishing that it was a reasonable management action. On brief Bureau Counsel indirectly indicates that the seating configuration employed by PAA may have been too low, but has proposed no specific adjustmant on this account. On the other hand Bureau Counsel proposes to call a halt to underwriting the higher expense of the B-377 with mail pay for 1953 and subsequent years.

• • • •

Apart from higher operating expenses, the remaining area which is generally agreed to be responsible for a substantial part of PAA's higher need is the difference in net yields of the carriers. PAA's ton-mile yield for all years here concerned was lower than that of TWA by 5.15 cents per revenue ton-mile, 6.9% below the TWA level. PAA computes its need for the 1948-1952 period attributable to this factor at $10,739,000. Though discussed under the heading of yield, it is recognized that traffic composition accounts for a part of the difference. PAA claims that a part of this need stems from the fact that its foreign mail volume, the highest yield traffic, was a substantially smaller part of its traffic volume than was TWA's. Bureau Counsel has accepted PAA's foreign mail contention in part.

During the review period TWA-International earned

$14,687,000 from carriage of foreign mail, PAA's entire Atlantic Division earned $11,169,000. PAA's Transatlantic-Europe-Asia sector accounted for $7,931,000 in foreign mail revenue. Thus there is an indicated PAA deficiency of such revenue of 6.8 million dollars over the segment and period concerned. PAA submits that this difference was beyond the control of management and explains that much of its apparent excess need. TWA argues that the development of foreign mail traffic is within the control of management in much the same manner as other commercial traffic and that PAA had access to markets as great as those of TWA. Bureau Counsel agrees generally with

13167

the position of TWA except with respect to access to foreign mail from Spain and India. Internal handling of foreign mail in these countries concentrates it essentially at Madrid and Bombay, served by TWA and not by PAA. Bureau Counsel would class this situation as beyond the control of PAA management and recognize $1,172,000 of the apparent excess need as attributable thereto.

Mail poundage data furnished by the Post Office Department supports generally the position taken by TWA as to the size of the foreign mail markets served by PAA and TWA. Thus, in 1948,[130] foreign countries served directly by PAA originated 631 thousand pounds of foreign mail, those served by TWA originated 659 thousand pounds. 1952 volumes grew to 1.5 million pounds for PAA countries, 1.6 million pounds for TWA countries. For Spain and India such data shows that for the years 1948-1952 PAA received 44,000 pounds of foreign mail as compared to TWA's 276,000 pounds.

Upon consideration of the available evidence it is con-

[130] All references to years for this data is to U.S. Government fiscal years.

cluded that the proper result lies between the position of Bureau Counsel and PAA. The full credit claimed by PAA is not warranted. There is ample evidence that the dispatch of foreign mail by the countries concerned varies between carriers in the interests of better service. France has varied its use of U. S. carriers from time to time on that basis. Ireland gave PAA 46.2% of its foreign mail in 1948, 14.0% in 1949, (split between 3 U. S. carriers), and 38.3% in 1952 (2 U. S. carriers). The variations in themselves indicate a flexibility, and PAA's failure, except for 1948, to obtain a proportionate share of the total volume. Great Britain has made relatively equal distribution among U. S. carriers serving there. German mail has moved in larger volume via PAA than TWA since the latter inaugurated its Frankfurt service in 1950. Italian mail has stayed predominantly with TWA since PAA began service to Rome in 1951. These differences are found to be a reflection of the suitability of the two carriers' services for movement of the foreign mail concerned and warrant no resultant adjustment because of inequal opportunity. On the other hand, it is found that TWA's service to Switzerland and Greece gave it foreign mail opportunities which were substantial and were beyond the net comparable opportunities of PAA. There follows a tabulation of the foreign mail poundage originated in the ten countries originating the greatest weights in the years 1949 and 1952, showing the pounds carried by PAA and TWA.

(13168)

13168

Country	1949 Rank	1949 Tot. Pounds (000)	1949 PAA (000)	1949 TWA (000)	1952 Rank	1952 Tot. Pounds (000)	1952 PAA (000)	1952 TWA (000)
Great Britain	1	335	49		1	535	56	56
France	2	233		38	3	227	51	49
Germany	3	182	79		2	290	58	43
Italy	4	155		80	4	210	7	98
Switzerland	5	80		70	5	72		24
Ireland	6	78	11	13	6	70	27	43
Greece	7	57		57	8	63		58
Belgium	8	50	19		9	56	22	
Spain	9	50	5	45	7	65	7	43
India[131]	10	37	13	13	10	35	0	18
Tot.[132]			176	316			228	432
Tot. excluding Spain and India			158	258			221	371

In the first four countries and Ireland it was indicated that the two carriers have essentially equal opportunities. In Spain and India they have not had equal opportunity during the review period. In the other three of the ten listed it is clear that TWA, in Switzerland and Greece had substantially greater opportunity for foreign mail than PAA had in Belgium. Both of these TWA points had a larger total air mail movement than Belgium and the latter country's national carrier, Sabena, has been conducting transatlantic service in appreciable volume

131 Czechoslovakia would rank 9th in 1949 and 12th in 1952 based on total pounds, but practically none was given PAA.

132 Out of 9 additional countries originating more than 1,000 pounds of foreign mail in 1952, 37,000 pounds went via PAA, 36,000 via TWA.

during the review period. Transatlantic frequency operated by Swissair was appreciably lower until the end of the period. Greece has no carrier operating across the Atlantic Ocean. These facts appear reasonably related to the volume of foreign mail moved by TWA and PAA from these countries and it accordingly appears proper to recognize the excess of TWA's foreign mail revenue from Switzerland and Greece over that of PAA from Belgium as an additional difference which was beyond the control of PAA. The approximate amount attributable to this difference is $2,087,000. Added to the $1,172,000 for Spain and India the total PAA deficiency of foreign mail revenue which appears to have been beyond the control of management is $3,259,000.

However, this total amount cannot be allowed PAA as a credit against the indicated excess need. The basic figure employed to assess the magnitude of PAA's excess need was TWA's break-even need per revenue ton-mile. Break-even need is the net excess of expenses over revenues expressed in terms of ton-miles of revenue traffic. Thus, if a constructive addition of traffic is found warranted there must be a constructive displacement of the lower yield traffic which actually moved since the comparative base used is the carriers' revenue ton-miles. Such

analysis indicates that the constructively displaced other traffic produced revenues of $946,000, indicating a net difference of $2,313,000 which is found to be a justified PAA need resulting from a part of its foreign mail deficiency which was beyond management's control.[133]

Both Bureau Counsel and TWA take a firm position that all other factors affecting yield and composition of traffic

---

133 Appendix H sets forth the detailed computation.

is a matter completely within the control of management. They submit that the regular tariff fares and charges of both carriers have been identical between major competitive points and that authorized operations between such points permit the same flight mileage. PAA has offered no evidence to contest these points. The explanation of the remaining lower yield, according to TWA and Bureau Counsel, rests in (1) fare absorptions, (2) prorates, (3) special promotional fares, (4) traffic composition, and (5) acceptance of "soft" currencies. Bureau Counsel does not condemn all such practices but submits that a fair balance must be maintained or else the need will suffer; that management must be ever mindful of the end result, whether or not their policies will actually reduce break-even need.

The position of Bureau Counsel and TWA must be upheld. The essential justification for any of the practices which attract additional traffic at reduced ton-mile yields must be that it adds to the profitability of the carrier's operation. In a sense, the yield level is but another facet of the capacity and load factor question. These are normally considered in terms of available ton-miles and revenue-ton-miles. But obviously if the revenue ton-miles for one carrier are obtained at a lower yield than another then the load factor comparison is defective for assessing the relative profitability of the service. If PAA load factors, which were proposed for consideration in several other issues, were weighted to reflect the lower yield it would call for an average reduction of 5% in load factors over the 1948-1952 period. Had this approach been used it is clear that there would have been additional challenges of the capacity operated by PAA. But whether the issue be viewed from the capacity or yield angle it is found that the result is one for which management must be held re-

sponsible. It is found that the PAA actions which underlie the excess need which has been identified as related to lower average yields was uneconomic and inefficient under the standards of the Act and cannot be recognized for mail rate purposes. * * *.

AOA Property Values:

As a result of the AOA merger PAA will now receive the additional mail pay herein found due AOA for its transatlantic services. Since the value of AOA equipment when placed on PAA's books accounted for the purchase price paid, the parties have agreed that these book values must now be reduced to offset the added AOA mail pay. Depreciation, gains from aircraft sales, and investment adjustments are involved and are believed to be reflected in accord with the agreement in the appropriate appendices. The resultant break-even need of PAA for the review period is found to be $49,544,000[134] under the standards of the Act.

13170

* * * *

Rates of Return:

Both TWA and PAA contend for a substantially higher return on investment than the 10% which has been the standard used by the Board in recent cases for future rate periods for international operations. TWA urges a return of 13% for both past and future periods. PAA contends for a rate of 13.75% for the future period and not less than 10% for the past period. Bureau Counsel proposes that the Board adhere to the established 7% rate for the

134 Appendix I summarizes the effect of the decision of each issue on break-even need by years.

past period and that it adopt a rate of return for the future that will differentiate between the rate for debt and equity capital, allowing actual debt charges for that portion and a rate of 11% on the equity portion. Bureau Counsel's proposal gives a future rate of return of 8.697%[136] for PAA and 8.03% for TWA.

All parties agree that the basic requirements of a fair rate of return are those set forth by the Supreme Court in the *Hope Natural Gas Co. Case*[137] in the following language:

> "The rate-making process under the Act, i.e., the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests. Thus we stated in the *Natural Gas Pipeline Co.* case that 'regulation does not insure that the business shall produce net revenues.' 315 U. S. p. 590. But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. *Cf. Chicago & Grand Trunk Ry. Co.* v. *Wellman*, 143 U. S. 339, 345-346. By that standard the

---

[136] PAA's capital structure in 1953 was changed by added debt financing after the close of the hearing. PAA has set forth such data in post-hearing exhibits nos. PA-198 and 199. Bureau Counsel has agreed to the receipt of these exhibits in the record together with exhibit BC-175 which sets forth Bureau Counsel's revised position based upon the later data. The post-hearing exhibits are received of record. Discussion of the issue herein will employ the revised data.

[137] *Fed. Power Comm.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

The diverse results reached stem from different approaches, analytical techniques and ultimate weighting of available data.

In arriving at the opposed fair rates of return each party has dealt with it in three parts: (1) the rate required for equity capital; (2) the rate required for debt capital; and (3) the debt-equity capital structure which should be used. The first of these is the most significant and the most controversial.

The test is agreed—the return to the equity holder should be commensurate with returns on investments in other enterprises having corresponding risks. Disagreement arises in identifying the "other enterprises having corresponding risks." Bureau Counsel sees no need to give substantial consideration to other enterprises since there exists a period in excess of ten years for which data is available for the air transport industry itself. Bureau Counsel's recommended rate on equity is based upon the "historic earnings-price ratio" for that period and industry. TWA contends that the investment risks for air transport companies correspond to those for manufacturing enterprises. The average earnings-price ratios for 47 industrial enterprises having quality ratings assigned by the Fitch Publishing Company covering the same quality range as air transport common stocks was taken by TWA as the proper standard. PAA placed its essential reliance upon the earnings-price ratios of the big four domestic air

carriers for the recent three-year period 1949-1951, but varied upward from a direct application of those results by assuming a different "growth rate" and "pay out ratio."

TWA's proposed rate of return on equity rests heavily upon the conclusion of its expert witness that the risks in the air transport industry correspond to those of industrial enterprises generally. The approach to this conclusion was on a subjective basis. The expert witness set forth ten factors which, in his opinion, influence investors' choices as to stock purchases.[138] He found that the airline industry met these criteria favorably only on one count—that of growth. Bureau Counsel rejects any attempt to determine the proper rate of return on the basis of a judgment evaluation of the risks of the air transport industry. Any expert investigator's study toward that end must necessarily weigh many influencing factors, earnings and their fluctuations, dividends, growth, the unique subsidy provisions of the Act, etc. Objections to such a subjective approach

13172

are summed up in the Federal Communications Commission study on rate of return[139] as follows:

> "[It] is unnecessary in the determination of public utility return to attempt any precise evaluation of the degree of risk inherent in the particular enterprise. In fact, it may be said that any such evaluation by an investigator, even if successfully made, would be futile. The importance of risk arises from

138 The ten factors were: (1) Consistent and stable earnings; (2) Reasonable dividends; (3) Low operating ratio; (4) Low wage ratio; (5) Good credit standing and ability to raise new common capital; (6) Absence of early and sizable maturities; (7) Slow plant obsolescence; (8) In a regulated industry, a monopoly position; (9) Stable demand in good and bad times; and (10) Growth.

139 Federal Communications Commission, "The Problem of the Rate of Return in Public Utility Regulation," (1938).

its influence on investors, and only this influence need be measured. An evaluation of risk from any other approach might reflect simply the investigator's reactions to the risk element, whereas it is the investor's reactions that are of importance. Measurement of the cost of capital is therefore deemed to constitute a sufficient measurement,—in fact, the only significant measurement, of both the risk and 'pure interest' elements in the rate of return. In other words, all of the elements of risk affecting a particular enterprise are ordinarily reflected in its costs of capital, which are determined by the amounts which must be paid to investors to induce them to supply the capital needed in the enterprise."

The TWA use of an investment publishing company's quality ratings is subject to these deficiencies. The expert witness who sponsored this approach was unable to state in other than general terms the basis used in arriving at the Fitch quality ratings. He did not profess to agree in all cases with those ratings. Such considerations are found to detract from the reasonableness of TWA's approach to the issue. The more direct "cost of capital" approach employed by Bureau Counsel, and in essential part by PAA's expert witness, is considered to be basically sound.

However, the "cost of capital" analysis is not free of difficulty. As PAA submits, if the *only* thing in which investors were *ever* interested was current earnings, then the earnings-price ratio would provide a direct basis for computing what rate of return should be fixed on equity investment. But obviously this is not true for the air transport industry investor. If it were, stock would be worthless in loss years. The fact that it has retained a positive value in such years establishes that the investor weighs the bad

against the good years and is making an investment essentially upon what he perceives to be the long-term future prospects for the industry. This is generally recognized by all parties, but has led to differing use of available data, leading to the several different rate of return recommendations.

In working with earnings-price ratios for air carrier common stocks over the twelve-year period 1940-1951, Bureau Counsel employed data for all domestic trunkline carriers. For any year and carrier in which there were negative earnings (loss) the carrier was eliminated in deriving the average earnings-price ratio for that year. To compensate for the elimination of all negative values Bureau Counsel also eliminated from computation of the average the one highest earnings-price ratio for each year.

13173

The resulting earnings-price ratios by years and for the twelve-year period for the domestic trunklines were as follows:

Year	Earnings-Price Ratio (%)
1940	4.40
1941	4.36
1942	14.37
1943	6.64
1944	5.78
1945	3.00
1946	3.00
1947	3.25
1948	4.39
1949	8.18
1950	13.30
1951	11.33
12-Year Average	6.83

The apparent and substantial spread between the earnings-price ratios in this period was credited by Bureau Counsel to speculative and short term influences. All parties have testified to the factors which existed during this past period which contributed to an abnormal situation. The initial years, 1940-1945, were war years. High traffic volumes and non-availability of additional equipment created a situation tending to inflate stock prices in anticipation of post-war expansion and profits. The 1946-1948 period was an unexpected period of "profitless prosperity" for the domestic trunklines in which severe reverses were experienced. Then, beginning in 1949 the ratios rose to the highest sustained levels of the period. In its 1953 decision dismissing the *General Passenger Fare Investigation*[140] the Board observed with respect to the carriers' recent earnings that, "looking at these years alone, such earnings must be considered excessive when measured by any reasonable standard applicable to a regulated industry." Bureau Counsel, in effect, submits that the investors' appraisal of these recent years was similar and that the stock prices accordingly discounted such earnings as abnormal, giving rise to abnormally high earnings-price ratios. To adjust for the several abnormal periods within the twelve years reviewed Bureau Counsel has proposed that it be considered in two parts, 1940-1948, and 1949-1951, and that each period be given equal weight in determining the "historic earnings-price ratio." The resultant ratio so derived is 8.2% which Bureau Counsel employs as basic part[141] of the equity return requirement.

PAA's expert witness rejects Bureau Counsel's use of earnings-price ratios of the domestic trunklines for the years prior to 1949 and also the unweighted use of data

140 Order No. E-7376, May 14, 1953.

141 Additional allowance is made for international risks, flotation costs and uncertainties which increase the final figure to 11.0%.

for carriers other than the big four. His approach employed only the earnings-price ratios for the big four and only for the years 1949-1951 and indicated a required basic equity return of 11.3%. Inclusion of 1952 data would increase the rate to 12.06%.

13174

Much detailed data was presented by all parties on this issue to prove each primary position and conclusion. It is not reviewed herein in detail. The most significant conclusion to be drawn therefrom is that the equity investor in airline stocks was optimistic during the war years, justifiably pessimistic in the post-war "loss" years, and has, since 1949, evidenced caution in pricing such stock. The variations of airline stock prices or of earnings-price ratios during these years in comparison with other established stock groups—utilities, rails, industrials—support this observation. Despite the fact that there exists thirteen years of public financing experience for the airlines it is apparent that a substantial part of that history covers years that were abnormal, and that the proper place of airline stock with respect to the more established groups is still in a process of evolution and appraisal. Bureau Counsel's "cost of capital" approach, to the extent that it eliminates all negative and the highest positive earnings-price ratios and weighs 1940-1948 experience equally with 1949-1951 (1952) moves from an objective to a subjective approach. In effect it opines that the investor is currently appraising, or should be currently appraising, airline stock on that basis. But in this field the expertise of the Board or of its staff is of little value. The evaluation which must be given controlling weight is that of the equity investor to whom the airlines will turn to raise added capital for future expansion. Since 1948 the airline equity purchaser has shown reasonable consistency as measured in terms of the earnings-price ratio.

Of all the years since 1940 these, in retrospect, appear to represent a more normal period than any other for the air transport industry. Even here the investor may be tending to underprice airline stock in light of the 1946-1948 losses, or he may be discounting high earnings as abnormal because of a high level of economic activity caused by the Korean conflict. But whatever the considerations may be, and whatever the weight assigned the possible factors, the investors' net summation thereof would appear to be reflected in recent earnings-price ratios. This is the common stock market which the airlines presently face in seeking to raise equity capital.

There is no disputing that the standards of section 406 of the Act require the establishment of a mail rate which will permit the carrier, "under honest, economical and efficient management . . ." to grow. Such growth will require new capital and the Board would be remiss in its duties under the Act if it failed to recognize the investor's current earnings requirements for such capital. It may be that the investor's current appraisal of airline stock underprices its earnings value. If that is true future events will establish the fact and investor recognition will be evidenced by lower earnings-price ratios. * * *

* * * PAA submits that data for the big four carriers only should be used since, in terms of investment, they represent about 70% of the domestic industry and because their individual total capital and future capital requirements are comparable in size to those of PAA's Atlantic Division. Bureau Counsel's average earnings-price ratios have included all domestic trunkline carriers and derived an arithmetic average, thus giving the ratio

13175

for the smallest (investment) carrier the same weight as the largest. For the present purpose it appears, as PAA contends, that the data for the big four carriers is the

most appropriate. If other domestic trunklines were included it would be proper to weight the carriers in terms of relative equity investment. Specific data was not presented to make such a weighted average but from comparison of the arithmetic averages for the big four and other trunklines it is clear that a weighted average of all domestic trunklines would vary but slightly from the arithmetic average for the big four.

Bureau Counsel has presented a refinement of computation of the earnings-price ratios which appears proper for incorporation. It is labeled the March-October method. The earnings-price ratios which have been heretofore discussed are "annual" ratios. They relate the earnings for a given year to the average market price of stock for the same year. The March-October method relates earnings for a given year to the market prices for October of that year and March of the following year for the reason that investor information as to corporate earnings for the first half of a year or for a full year is normally obtained a few months after the close of such period. The March-October method thus affords an improved correlation of earnings information and market pricing by the investor. Using the March-October method the average earnings-price ratio for the big four carriers in the 1949-1952 period is 11.2%. This is concluded to be the required basic rate of return on equity capital for application to the future rate period herein. It is generally agreed by the parties that to the basic rate of return on equity there must be added a provision for "costs of flotation" of new stock and for "market pressure" which normally depresses the market price at the time new stock is issued. PAA has proposed an allowance of 12.5%, TWA an allowance of 15%, and Bureau Counsel an allowance of 11% for these factors.

• • • •

The costs of flotation represent the legal fees, underwriter's spread and other expenses incident to sale of a new stock issue which produce a net amount to the company below the gross amount for the stock at the offering price. PAA presented an analysis of the flotation costs of airline common stock issues for the years 1936-1949 which derived an average cost of 9.73% of the gross proceeds. That figure is not questioned, only the use made of it. PAA would apply it directly to increase the basic equity return rate from 11.2 to 12.4%. Bureau Counsel objects to a full application of the flotation cost allowance on the ground that since 1943 about 40% of the industry's equity growth has come from plowed-back earnings rather than from new stock. Since there is no flotation cost to plowed-back earnings Bureau Counsel would reduce the indicated 9.73% flotation cost to 60% of that amount. Bureau Counsel's adjustment is well founded, * * *.

* * * *

Market pressure is described as the normal drop in market price of a company's stock accompanying the flotation of a new issue. It is explained as a normal anticipation that the new capital will not immediately be put into full productive use and hence that earnings per share will be temporarily depressed. Bureau Counsel apparently allowed 5% for such factor in his total proposed allowance of 11% on the basis that underwriters apparently required that new issues be priced 5% below the market. * * *

13176

The foregoing derivation, resting upon the investment experience of the big four domestic carriers, still leaves for determination the question of an added return increment to cover the risks peculiar to international operations. Bureau Counsel has proposed to add 1 percentage point to the equity return to cover such risks. PAA urges retention of not less than the 2% differential which the

Board has employed in the past, which becomes 2.66% when related only to the equity component on an assumed 75-25% split between equity and debt. TWA takes no issue with the 1 percentage point increment proposed by Bureau Counsel.

Any attempt to obtain a direct investor appraisal of the added risks of international operations appears futile. Such an appraisal might be reasonably established if earnings-price ratios for the international carriers were consistently higher than those of domestic carriers. Comparing TWA with the other three of the domestic big four for the 1949-1952 period might be said to give such an indication. In each of those years TWA had the highest earnings-price ratio of the big four, being above the next highest ratio by an average of 2.02 percentage points. But looking at PAA, the only U.S. air carrier engaged entirely in overseas and foreign operations, the reverse indication is obtained. PAA's earnings-price ratios for the 1949-1951 period have averaged 6.7% as compared to 10.4% for the big four (annual method). PAA submits that its low earnings-price ratio cannot be construed to establish an investor opinion of less risk in international operations. It points out that its stock in this period has been priced below book value and that the market price has accordingly been sustained by the book value rather than by earnings, in anticipation of improved earnings. No party suggests that there is less investment risk in international operations than in domestic, but it is clear that no direct investor appraisal of the added risk can be obtained from earnings-price ratios. Evaluation of the added risk must accordingly be made on a subjective basis, attempting to identify and weigh the various factors which represent the additional risk. Such appraisal must rest heavily on informed judgment since there is little historic data to provide a base for a quantitative analysis.

PAA has advances eight factors on brief which it submits constitute added risks to international carriers. The first asserts that international carriers, being in need of subsidy, incur substantial disallowances when rates are fixed on a retroactive basis which reduces the rate of return to a sub-marginal level. The fact that the review period herein is unusually long can be recognized, but it does not follow that this is a risk peculiar to international carriers or that the duration of an open mail rate period is beyond the carrier's control.

Second, PAA submits that the location of substantial amounts of tangible and intangible property abroad creates special risks in unstable international conditions. Some evidence of record would indicate that TWA incurred added expense because of the 1948-1949 War in Palestine in closing and reopening its station at Jerusalem, but property losses were apparently covered by insurance. The major uninsured property loss of record herein was incurred domestically by TWA in the Kansas City flood.

13177

Third, PAA submits that international traffic is influenced not only by business conditions in the U. S., but by business and political conditions in the foreign countries as well. This point can be generally recognized. The review period has, of course, been one of post-war recovery in the major European countries during which business conditions have generally improved even though there has been much political change. Traffic has been steadily increasing and the future forecast herein is founded upon established trends. However, if adverse traffic changes are met by reasonable management action in the scheduling of capacity, and if the mail rate is properly related to ca-

pacity flown, it would not appear that such risks are of appreciable significance.

Fourth, PAA submits that actual war has an adverse effect on international carriers not felt by the domestic; that substantial portions of the international carriers' operations may be expected to be put under Government contract, as were PAA's in World War II. In that contract operation PAA notes that its return on investment was only 6.63% over a 4-year period. Projection of past experience to the possibility of future major conflict in this age of atomic energy is, of course, not possible.

Fifth, PAA notes that international carriers are subject to risk from devaluation of foreign currencies. There have been such devaluations during the review period. Commercial rate adjustments to offset their effect always lag behind the devaluation action. On the other hand, an approximate balance of expenditures against revenues in the devalued currency countries would largely eliminate such risk. Evidence of record does not pinpoint such a balance, but indicates a reasonable relationship which would discount any net effect on the carrier approaching the magnitude of the *prima facie* devaluation.

Sixth, PAA submits that international carriers have a much greater exposure to additional competition resulting from foreign government action. Competition from foreign carriers has increased during the review period. This is reflected in the traffic trends upon which the forecast is based. Essential considerations here would appear similar to those set forth with respect to PAA's third contention. The same is true with respect to PAA's seventh point which notes the ability of foreign governments to favor their own airlines through capacity limitations on competitors, limitations on currency conversion for nationals,

etc. All of these points which would indicate some higher susceptibility of international traffic to diversionary influences not present for domestic operations are essentially related to the problem of scheduling capacity to meet demand. A longer normal advance reservations period for international traffic may well offset such risks.

Eighth, and finally, PAA submits that higher operating ratios[143] of international airlines as compared with domestic airlines constitutes an

13178

added risk. It is a fact that operating ratios for the domestic trunklines have been lower than those of international carriers since 1949. For the earlier two years of PAA's presentation, 1947 and 1948, the converse was true. From such data it cannot be concluded that there is any inherent reason why the operating ratio should be higher for international airlines. The high cost of B-377's operated by PAA and Northwest in 1949 and subsequent years would be a substantial contributor to the difference in results recorded. A further factor is obviously that the domestic carriers moved more quickly to closed mail rate operations in which the Board recognizes a higher earnings rate. It is clear that the air transport industry is a high operating ratio enterprise as compared to other regulated utilities. Investment productivity is high but hinges significantly on operating efficiency, on the selection of increasingly efficient aircraft and on the maintenance of high load factors. But the risk attending this high operating ratio is one that works both ways. Small improvements in operating efficiency can effect appreciable gains in net

143 Ratio of expenses to revenues.

return, just as small deficiencies can work the opposite result.

From the foregoing review of the alleged factors creating a higher international risk it is concluded, as a matter of judgment, that a one percentage point increment added to the equity rate of return is a fair and reasonable provision for the added risks of international operations. Added to the other considerations it is found that the fair and reasonable future rate of return for the equity capital of the international carriers herein is 12.3%.

Turning to the rate of return for the debt portion of capital the area of disagreement between Bureau Counsel and the carriers is small and simply stated. Bureau Counsel proposes to use the current cost of debt for each carrier which he submits is 3.55% for PAA and 3.56% for TWA. The carriers propose the use of a 3.5% rate as representing the current average cost of debt for the airline industry. The adoption of either contention is related to the more significant issue of whether the rate for each carrier should be based upon its individual debt-equity ratio, as Bureau Counsel contends, or on an industry debt-equity ratio supported by TWA. TWA submits that a 40% debt component is representative of the industry capital structure and should be employed. Bureau Counsel would use the projected debt component of each carrier for 1953 in constructing the future rate of return, approximately 32% for PAA and 46% for TWA.

The Board has not previously varied the future rate of return for trunkline carriers because of differences in capital structure. One possible exception is noted in the 1949 decision setting final mail rates for Capital Airlines for the years 1947-1948.[144] Upon finding

---

144 *Capital Airlines, Mail Rate Case*, 10 C.A.B. 705 (1949).

that the carrier's capital structure in those years was almost entirely composed of debt capital (2% equity) the Board set the rate of return at 6% rather than the usual 7% for past periods, stating: "We believe it is sound policy to provide for a lower rate of return for carriers with top-heavy debt structures, in order both to reflect the foregoing factors and to establish the incentive for healthy financing best adopted to the development of air transportation under the Act."[145] On the other hand, TWA notes that the Board has more recently continued to fix rates of return of 10% for international and Alaskan air carriers[146] without regard for variations in capital structure.

In support of the so-called "differentiated rate of return" Bureau Counsel submits that the use of a uniform rate of return does not provide for the actual capital costs of any individual carrier except by sheer accident. Thus, a uniform over-all rate of return of 10%, assuming a 3.5% interest rate on debt and debt components of 25 and 50% for two carriers, would result in a return on the equity component of 12.2% for the first carrier and 16.5% for the second. Going a step further, assuming a debt component of 75% would give an equity return rate of 29.5% Bureau Counsel submits that a uniform over-all rate of return thus produces earnings to stockholders which

---

145 *Capital Airlines, Mail Rate Case*, 10 C.A.B. 725. (1949).

146 *Chicago & Southern Air Lines, Latin American Operation*, Order No. E-6908, October 22, 1952, affirming show cause Order No. E-6850, October 2, 1952; *Edward A. Brennan d/b/a Lon Brennan Air Service, et al., Mail Rates*, Order No. E-7206, March 6, 1953, affirming show cause Orders Nos. E-7166, E-7167, February 18, 1953; *Northern Consolidated Airlines, Inc., Mail Rates*, Order No. E-7289, April 9, 1953, affirming show cause Order No. E-7231, March 16, 1953. *Northeast Airlines, Inc., Mail Rates* Order No. E-7443, June 5, 1953, affirming show cause Order No. E-7368, May 11, 1953.

vary directly with the proportion of debt and encourages the practice of trading-on-the-equity[147] which leads to top-heavy debt and an undesirable financial structure. But the carrier parties submit that the leverage created by a high debt component works both ways, that the risk of an enterprise is not varied by the capital structure but is merely shifted from one security holder to another. In the determination of the proposed differentiated rates of return Bureau Counsel recognized that leverage would add to the cost of

13180

equity capital for the high debt carrier and endeavored to measure a proper allowance therefor by reference to a comparison of earnings-price ratios and the senior security capital of the domestic trunkline carriers for the 1949-1951 period. By grouping carriers and averaging each group Bureau Counsel's witness derived an indicated leverage adjustment of .368 percentage points for each 10 points that senior securities exceeded the industry average of 30%. The indicated adjustment was rounded to .5 in recognition of the rough nature of the approximation. There are substantial reasons for rejecting this leverage adjustment proposed by Bureau Counsel. First, as the Bureau's witness observed, there is no pattern evidenced between the proportion of senior securities and the exper-

147 "[The] use of fixed-income securities, whether debt or preferred stock in the hope of adding to the return of the owners, is known in financial circles as 'trading on equity'. Owners of a business use their 'equity' or ownership investment, as a basis for obtaining funds from others which they hope to use with sufficient profit so that it will enhance their own rate of return. . . . Trading on equity is also referred to as 'leverage'. The larger the amount of prior securities in relation to the equity of the common stock, the higher the leverage and the higher the possible rate of return on the latter." Badger & Guthmann, "Investment Principles and Practices", p. 75, (1951).

ienced earnings-price ratios for individual carriers. Only by grouping and averaging carriers was it possible to obtain any indicated leverage adjustment. The basic conclusion to be drawn from this data is that leverage has an indeterminate effect on required earnings which is of lesser significance to the investor than other factors relating to individual carriers.

The inability to obtain any reasonable indication of the effect of—leverage on investor earnings requirements is believed to present significant reasons for rejecting Bureau Counsel's proposed differentiated rate of return. In the cases cited by Bureau Counsel which adopted the differentiated rate of return the essential reliance of the regulatory body was upon the experienced earnings-price ratios, capital structure and recent costs of equity capital for the individual companies for which rates were being set.[148] It may be conceded, *arguendo,* that this is a reasonable and perhaps the most accurate measure of a fair rate of return for an enterprise that has shown highly stable investment characteristics over a substantial past period. But the total evidence of record on the rate of return issue establishes with unmistakeable clarity that such stability is lacking for air carriers. PAA strongly resists any suggestion that its experienced earnings-price ratios give a reasonable measure of a fair future rate of return on equity capital. TWA, while it would benefit from having its future rate of return based upon its recent earnings-price ratios and recent experience as to cost of equity capital, still finds difficulty with the use of the actual split between debt and equity. TWA agrees with Bureau Coun-

148 *In the Matter of Northern Natural Gas Company,* 95 P.V.R. (NS) 289 (F.P.C., 1952); *In the Matter of Colorado Interstate Gas Company,* 95 P.V.R. (NS) 97 (F.P.C., 1952).

sel that the desirable capital structure for air carriers would have a high proportion of equity capital, but submits that to set a future rate of return based upon an existing present split would work to penalize a carrier which thereafter increased the equity portion. The air transport industry with its appreciable annual growth and ability to obtain short term equipment trust financing on aircraft, a major portion of total investment, is in a position to effect substantial changes in capital structure in relatively short periods. TWA's debt component dropped from 79% in 1949 to 46% in 1952. Eastern's rose from 24% in 1949 to 45%

in 1952. The big four, despite an opposite trend by Eastern, reduced the average debt component from 45% to 34% in the 1949-1952 period. PAA's debt component was low, about 24% in 1952, but increased to 32% in a short period after the close of the hearing. The general trend of the industry toward a lower debt component since 1948 would appear to indicate a recognition of the desirability of a capital structure composed primarily of equity capital. No carrier has in recent years had a capital structure so top-heavy with debt as that of Capital Airlines in 1947-1948.

In accordance with the foregoing it is concluded that there does not exist such a background of investment stability for the air transport industry or for the individual air carriers here concerned as would warrant setting individually tailored rates of return on the differentiated basis proposed by Bureau Counsel. Having relied upon recent earnings-price ratios of the big four in

determining the basic earnings required on equity it is found appropriate to refer to the same group to establish a reasonable split of debt and equity in the capital structure.

* * * *

As has been previously indicated it has been concluded that the 7% rate of return for the past period should be maintained in this case. A basic reason underlying that conclusion is that Board decisions have been reasonably uniform in applying that rate to past mail rate periods, whether for domestic or international carriers, during the review period. Thus, investors have had reasonable notice that such rate would be applied. Whatever the new capital requirements were in that review period is now a matter of history. Any current appraisal of the cost of capital in the 1946-1952 period resting upon average industry or big four experienced earnings-price ratios and capital structures would indicate that an overall 7% rate of return was adequate. The entire concept of past period mail rates is unique among air carriers of all regulated industries. During an open rate period many of the normal and abnormal risks of air transport operations are reviewed as past fact and covered by mail pay, which risks would be absorbed by the carrier if it were under a final future mail rate. Probably the major normal risks so treated are traffic volume changes and expense levels. Abnormal risks so covered herein are items such as aircraft groundings, strikes, TWA's flood loss. Thus, there is an appreciable degree of security which attaches to a carrier on an open rate as compared to one on a closed or final mail rate. That shifting of risks from the carrier to the Government must properly be reflected in lower rates of return for past mail rate periods.

PAA protests that the protection of the open mail rate period is highly overrated; that, in fact, the normal Board review of the actions of a carrier during a past period inevitably results in substantial disallowances which reduce the net return to a figure well below the professed 7%. PAA submits that the Board should recognize this fact and increase the normal 7%, not to a level that would offset the disallowances in any given case, but to a level that would compensate for the average disallowances. But the argument cannot be accepted. The Board does not apply different standards to past and future rate periods. As it normally disallows charitable contributions, losses on executive aircraft and

entertainment expenses on a past period review, it similarly makes no allowance therefor in forecasting a future rate. As it disallows past capacity because of unreasonably low load factors so it forecasts on the basis of reasonable load factors. The same is true with respect to revenue yields and expense levels. The essential advantage in the future final rate status is that the carrier has some leeway within the total forecast to offset deficiencies or added expense in one category by better than forecast efficiency in some other aspect of the total operation. To the extent that this provides an incentive to carriers to get on and stay on closed rates it should be maintained. But the essential justification for different rates of return between open and closed rate periods lies in the different risks assumed by the carrier. Recognizing the need provisions of the Act it cannot be concluded that the risks assumed by an air carrier during an open rate period are substantially in excess, if any, of those of other regulated utilities generally. A summary tabulation presented by

Bureau Counsel of Court and Commission cases on rate of return shows that the 1946-1951 average of all such decisions allowed a return of 5.82%. On the basis of the foregoing considerations it is concluded that the 7% rate of return for past or open mail rate periods is fair and reasonable and should be affirmed.

Future Rate Period:

As of the close of the hearing[150] the air carrier reports available to all parties ended with the year 1952. Each party accordingly presented its forecast of future operating results and mail pay need for the "future year" 1953. The regular Form 41 reports of each carrier filed up to the date of decision have been made of record by stipulation. By the time briefs were filed[151] Bureau Counsel took note of certain reported results through April, 1953, and accordingly modified his position somewhat with respect to 1953 forecast results. Bureau Counsel reserved the right to modify that position further on the basis of subsequently available data for 1953.

* * * *

Bureau Counsel will apparently urge that 1953 be reviewed as a past period on the basis of prior Board decisions which indicate that the latest available data will be reviewed as a check on the reasonableness of a future rate.[152]

---

150 March 19, 1953.

151 July 3, 1953.

152 *Colonial Airlines, Inc., Domestic System, Mail Rates*, Docket No. 2724, Order No. E-5777, October 9, 1951; *Pan American World Airways, Inc., Alaska Services, Mail Rates*, Docket No. 1499, Order No. E-6134, Feb. 19, 1952; *Reeve Aleutian Airways, Inc., Mail Rates*, Docket No. 3383, Order No. E-7325, April 23, 1953.

13183

TWA Future Rate:

* * * *

Apart from the question of the proper forecast trends there is an issue of some significance reflected in the expense item for flight equipment depreciation. Bureau Counsel allowed $4,241,000 in his forecast; TWA provided an amount of $4,864,000, a difference of $623,000. Both figures are based upon aircraft (and engines) of similar value at the start of the year. The difference arises from Bureau Counsel's proposed upward revision of residual values to 15%. Bureau Counsel would revise rates of depreciation only from 1953 forward which, in effect, compounds the reduction of depreciation expense for the forecast year depending on the age of the aircraft.[157] It has previously been indicated that an increase of residual value of aircraft and engines to 15% is found warranted. The Board has so found in recent decision,[158] and has announced that it will apply such residual values for all postwar aircraft for mail rate periods beginning with 1953. For aircraft and engines that have been partly depreciated toward some lesser residual value prior thereto the application proposed will produce a "bent line" rather than a "straight line" depreciation curve. Some distor-

---

157 A Constellation L-749A previously had a residual value of $50,000 which would become $112,000 on the 15% basis. The difference, $62,000, for a new aircraft, would decrease the depreciation charge by $8,850 per year; for an aircraft that is 3½ years old at the time the higher residual value is applied (January 1, 1953) the annual depreciation reduction would be twice that amount for the aircraft's remaining depreciable life.

158 *Northeast Airlines, Inc., Mail Rates*, Order No. E-7368, May 11, 1953, affirmed by Order No. E-7443, June 5, 1953; *Pan American World Airways, Inc., Latin American Division; Mail Rates*, Order No. E-7650, August 19, 1953, affirmed by Order No. E-7673, September 1, 1953; *Delta Air Lines, Inc., Latin American Operations, Mail Rates*, Statement of Provisional Findings and Conclusions, Order No. E-7738, September 21, 1953.

tion of data for short-term comparative use as between carriers will result, but it cannot be found that any carrier is prejudiced over the entire depreciable life of the equipment. TWA urges that the revised rate of depreciation be computed on the established 7-year life of such equipment but applied only to the life remaining after 1952. This would result in a reduction of the 7-year depreciation period and is not found warranted.

• • • •

Future Investment:

• • • •

13184

The sole issue is with respect to the amount to be recognized for working capital. The issue is the same as was discussed earlier with respect to the past period and the prior holding applies equally for the future year. The future year recognized investment accordingly conforms to the position of Bureau Counsel, with the necessary modifications of working capital to reflect the rulings on the various past period items.

• • • •

(13185)

Future Investment:

On the basis of Bureau Counsel's position on other issues there is no disagreement between Bureau Counsel and PAA as to future investment other than working capital.[160] Bureau Counsel submits that the available allocable working capital for the Atlantic Division in 1953

160 Consistent with the primary position taken with respect to future break-even need on a uniform basis with TWA, Bureau Counsel also submitted a primary position relating to investment on a uniform basis. . . .

is $11,608,000. PAA claims an allowance of $15,265,000 for working capital, equal to three months' cash operating expenses. PAA submits that even though it lacked some part of a full three months' cash expenses as working capital as of the start of 1953, it has usually maintained that amount in the past and will do so in the future. But future rates cannot allow for a promised or anticipated increase in working capital.

• • • •

Appendix 1

AMERICAN OVERSEAS AIRLINES, INC.
Transatlantic Final Mail Rate Case

Summary of Final Mail Pay
(In thousands)

	1946-7	1948	1949	1950	Total
Non-mail revenue	$32,242	$18,318	$18,971	$15,175	$84,706
Total expenses	36,273	20,864	22,773	18,924	98,834
Break-Even Need	$ 4,031	$ 2,546	$ 3,802	$ 3,749	$14,128
Return on investment @ 7%	1,619[1]	981	1,238	1,172	5,005
Provision for income taxes[2]	—	4	868	2,102	2,974
Total mail pay as recommended by Bureau Counsel	$ 5,650	$ 3,531	$ 5,903	$ 7,023	$22,107
Temporary mail pay received	6,371	3,775	4,188	2,981	17,315
Additional or excess (—) mail pay	$ —721	$ —244	$ 1,715	$ 4,042	$ 4,792
Recognized investment	$11,936	$14,016	$17,630	$22,668	—

[1] Amount provided for return on investment represents 14 percent of two-year average investment less return on investment applicable to pilots strike of $52,000, computed as 7 percent of $738,000 strike investment. This investment is 4.93 percent of annual 1947 investment of $14,972,000 per Exhibit BC 333 (Revised), page 3, computed on a time basis for the 18-day strike period.

[2] Provision for income taxes has been computed at a rate of 52 percent, using the same method as in Appendix AA (Revised) of Bureau Counsel's Brief to the Examiner. If the tax rate in the year of final award of mail pay is changed from 52 percent, the tax provision will be adjusted accordingly, and the corollary adjustments to PAA mail pay will also be made.

B418

(13185)

TRANS WORLD AIRLINES — INTERNATIONAL DIVISION

Transatlantic Final Mail Rate Case

Adjustments to Break-Even Need and Summary of Total Mail Pay

(In thousands)

Footnotes (Cont'd)

[a] Computation of adjustment to allocation of R-3350 BD engine maintenance expense to International Division[a]:

Direct Maintenance	
Total of KCOB engine overhaul expense[b]	$1,651,684
Adjustment at same percent as 1951 (14.95%)	246,927
Indirect Maintenance	
Ratio of KCOB direct labor to total KCOB expense[c]	30.47%
Amount of direct labor included in adjustment	75,239
Indirect maintenance expense per direct labor dollar[c]	1,089
Amount of indirect maintenance expense adjustment	81,935
Total adjustment to allocation to International Division	$ 328,862

[a] Based on same method followed in Appendix S of Bureau Counsel's Brief to the Examiner.

[b] Same rate of $6.17 per engine hour as 1952 times 267,696 engine hours (66,924 L-749 and L-749A aircraft hours x 4).

[c] Same as percent used in 1952.

TRANS WORLD AIRLINES—INTERNATIONAL DIVISION

Transatlantic Final Mail Rate Case

Computation of Cost of Navigator Strike, July 1953

(In thousands)

	Year — 1953		
	As Reported	Strike Period	Estimated Normal
Revenue Plane Miles			
Scheduled passenger service	15,606	507[1]	16,113
Non-scheduled service	104	—	104
Total revenue plane miles	15,710	507	16,217
Non-U.S. Mail Revenue	$48,795	$ 1,618[2]	$50,413
Operating Expense	52,445	301[3]	52,746
Operating Break-Even Need Before Adj.	$ 3,650	$–1,317	$ 2,333
Adjustments for Rate-Making Purposes[4]			
Korean Airlift Profit	$ —94		$ —94
Direct maintenance—flight equipment	157		157
Depreciation—flight equipment	—544		—544
Ground operations	—1		—1
Ground and indirect maintenance	—1		—1
Selling expense	—852		—852
General and administrative	—113		—113
Nonoperating Items	—37		—37
Total Adjustments	$–1,485	—	$–1,485
Adjusted Break-Even Need	$ 2,165	$–1,317	$ 848
Normal break-even need per normal rev. plane mile in scheduled service (4.46¢) applied to actual miles flown and to estimated miles lost	821	27	848
Break-even loss due to strike	$ 1,344	$–1,344	—
7% return on investment allocable to strike based on prorate of flight equipment in accordance with ratio of miles lost to total miles (3.13% x $19,590 = $613)[5]		—43	
Total strike cost		$–1,387	

TRANSATLANTIC FINAL MAIL RATE CASE

Comparison of Selected Selling Expense Items
Transatlantic and Big Four Carriers
1950 - 1953

		Transatlantic Carriers				Big Four Carriers				
		PAA ATLANTIC	TWA	AOA[1]	Total	AAL	EAL	TWA	UAL	Total
Ticket, Resrv. and Traffic empl. salaries (Acct. 6432-33) (000)	1950	$ 1,033	$392	$113	$ 1,538	$ 4,137	$ 3,448	$ 3,737	$ 3,665	$14,987
	1951	1,133	616	—	1,749	5,529	3,964	4,380	4,661	18,533
	1952	1,268	752	—	2,020	6,860	4,600	5,691	6,331	23,481
	1953	1,488	986	—	2,474	8,295	5,431	7,449	7,641	28,817
Commercial Revenues (000)[2]	1950	$32,690	$30,492	$14,185	$77,367	$107,786	$73,628	$66,568	$86,940	$334,922
	1951	45,719	34,802	—	80,521	149,693	91,438	89,764	104,097	434,992
	1952	55,132	40,765	—	95,897	171,827	108,101	105,901	133,508	519,337
	1953	59,419	45,145	—	104,564	193,301	130,213	127,581	151,013	602,108
Ratio salaries to com'l revenues	1950	3.16%	1.29%	0.80%	1.99%	3.84%	4.68%	5.61%	4.22%	4.47%
	1951	2.48	1.77	—	2.17	3.69	4.33	4.88	4.48	4.26
	1952	2.30	1.85	—	2.11	3.99	4.26	5.37	4.74	4.52
	1953	2.50	2.18	—	2.37	4.29	4.17	5.84	5.06	4.79
	Ave.				2.16%					4.51%
Selling expenses (000)	1950					$12,226	$ 8,685	$ 9,516	$10,792	$41,219
	1951					15,557	9,743	11,194	12,849	49,343
	1952					18,861	11,501	13,205	16,730	60,297
	1953					21,716	13,829	17,247	19,351	72,143
Selling expense ratio	1950					11.3%	11.8%	14.3%	12.4%	12.3%
	1951					10.4	10.7	12.5	12.3	11.3
	1952					11.0	10.6	12.5	12.5	11.6
	1953					11.2	10.6	13.5	12.8	12.0
	Ave.					11.0%	10.9%	13.2%	12.5%	11.8%

[1] AOA merged with PAA - Atlantic 9/26/50.

[2] Commercial revenues consist of passenger, express, freight, excess baggage, and other transportation revenues.

Source: Recurrent Reports and Form 41 Reports.

TRANS WORLD AIRLINES — INTERNATIONAL DIVISION

Transatlantic Final Mail Rate Case

Adjustments to Break-Even Need and Summary of Total Mail Pay

(In thousands)

	1946	1947	1948	1949	1950	1951	1952	1953	Total
Break-even need per Examiner's Report	$3,167	$5,813	$ 8,463	$ 5,611	$4,595	$2,733	$2,593	$ 2,036[1]	$ 35,011
Adjustments to Examiner's break-even need by the Board:									
Termination indemnity reserve accrual disallowance					$ −89	$−109	$ −94		$ −292
Cost of pilot strike	$−582[2]								−582
Cost of navigator strike[3]								$−1,344[5]	−1,344
Selling expense adjustment to allow 21% of commercial revenues						−520	−496	148[5]	−868
Executive aircraft retirement profit before allowance of 7% on investment		$ −35							−35
Elimination of accrual for flood loss reserve								−19[5]	−19
Reversal of reallocations recommended by Bureau Counsel:[4]									
Selling expense	−33	−13							−46
LaGuardia transit area expense	−37								−37
Excess engine maintenance allocation								−329[5]	−329
Total adjustments	$−652	$ −48	—	—	$ −89	$−629	$−590	$−1,544	$−3,552
Revised break-even need	$2,515	$5,765	$ 8,463	$ 5,611	$4,506	$2,104	$2,003	$ 492	$ 31,459
7% return on investment[6]	869	1,626	2,043	1,976	2,137	2,428	2,427	2,005	15,511
Provision for income taxes	1	50	−25	46	1,853	1,735	370	−80	3,950
Total mail pay awarded before tax effect of excess mail pay	$3,385	$7,441	$10,481	$ 7,633	$8,496	$6,267	$4,800	$ 2,417	$ 50,920
Temporary mail pay received	3,273	6,465	9,304	9,229	9,069	6,364	3,568	3,823	51,095
Additional or excess (−) mail pay before tax credit	$ 112	$ 976	$ 1,177	$−1,596	$−573	$ −97	$1,232	$−1,406	$ −175
Tax on additional mail pay at tax rate of 52%[7]	—	—	—	—	—	—	—	−190	− 190
Total additional or excess (−) mail pay after tax credit on excess mail pay	$ 112	$ 976	$ 1,177	$−1,596	$−573	$ −97	$1,232	$−1,596	$ −365
Total mail pay after giving effect to tax credit on excess mail pay	$3,385	$7,441	$10,481	$ 7,633	$8,496	$6,267	$4,800	$ 2,227	$ 50,730

[1] Break-even need for 1953 is obtained from Appendix C Supplement of Bureau Counsel's Brief to the Board.
[2] Cost of pilot strike increased from $506,000 to reflect substitution of final adjustments for those used in computation in Exhibit BC 248A.
[3] See Appendix 4 for details of costing of strike.
[4] Examiner did not rule on the propriety of these reallocations.
[5] Adjustments to 1953 break-even need are based upon Board findings for earlier years.
[6] See Appendix 5 for adjustments to investment.
[7] Should the effective tax rate be changed at the time the offset phase of this proceeding is decided, the additional tax payable in accordance with Internal Revenue Ruling 169 should be recomputed at the effective rate. The additional tax provision is distributed for administrative purposes to the most recent year for which additional mail pay is awarded.

TRANS WORLD AIRLINES — INTERNATIONAL DIVISION

Transatlantic Final Mail Rate Case

Computation of Cost of Navigator Strike, July 1953

Footnotes

[1] Revenue plane miles lost on account of the strike are estimated as the number of miles required to increase actual miles flown in July 1953 to a level which has the same relation to miles flown in June and August as the average ratios for the years 1952 and 1954. These ratios are 105.30% over June and 100.12% over August, derived from the mileages in the table below.

	Revenue Plane Miles in Scheduled Passenger Service		
	June	July	August
1952	1,316,345	1,389,108	1,379,315
1953	1,454,483	1,069,860	1,619,976
1954	1,746,006	1,834,786	1,843,404

Estimated normal mileage for July 1953 is 1,576,782 miles.

[2] Non-U. S. mail revenues lost computed from the average revenue per plane mile of $3.36 for June and August 1953 times the estimated normal miles less the actual revenue earned.

[3] Operating expenses saved computed in same manner as in footnote 2, using average expense per mile of $2.92.

[4] Adjustments to break-even need are those detailed in Appendix C of Bureau Counsel's Brief to the Board as amended by Appendix C Supplement and adjustments for 1953 in Appendix 3 of this opinion.

[5] The "plane mile" method of computing investment related to the strike period is used here in place of the "time" basis used in computing investment for the TWA and AOA pilot strikes, since the number of days duration of the strike and the amount of equipment immobilized are not known. However, if it is assumed that the aircraft hourly utilized for normal operations during the period of the strike would be the same as the average utilization during the remainder of the year, then the results would be approximately the same on either basis.

TRANSATLANTIC FINAL MAIL RATE CASE

TWA Recognized Investment

(In thousands)

	1946	1947	1948	1949	1950	1951	1952	1953
Adjusted cash operating expenses per Examiner's Report	$20,268	$28,014	$34,025	$32,958	$34,516	$37,435	$42,192	$46,5031
Adjustments to cash operating expenses related to Board findings:								
Termination indemnities					—89	—109	—94	—
Selling expense						—520	—496	148
Flood loss2						—620		—19
Reversal of reallocation of selling expense	—33	—13						
Reversal of reallocation of LaGuardia transit area expense	—37							
Reduction in allocation of engine overhaul expense								—329
Adjusted cash operating expenses	$20,198	$28,001	$34,025	$32,958	$34,427	$36,186	$41,602	$46,632
Three months cash operating expenses	5,049	7,000	8,506	8,239	8,607	9,046	10,400	11,658
Adjusted working capital included in recognized investment	$ 3,281	$ 5,375	$ 7,677	$ 8,239	$ 8,607	$ 9,046	$10,400	$ 7,695
Working capital recommended by Examiner	3,389	5,630	7,947	10,638	11,270	11,318	11,184	—
Variance from Examiner's findings3	$ —108	$ —255	$ —270	$-2,399	$-2,663	$-2,272	$ —784	—
Fixed investment per Examiner's Report	$ 9,024	$17,825	$21,510	$19,994	$21,924	$25,639	$24,275	$21,5654
Adjustments:								
Increase in investment adjustment to reduce to 11-month basis	—141							
Decrease in investment allocated to pilot strike5	187							
Investment allocated to navigator strike6								—613
Adjusted fixed investment	$ 9,070	$17,825	$21,510	$19,994	$21,924	$25,639	$24,275	$20,952
Total working capital and fixed capital	$12,351	$23,200	$29,187	$28,233	$30,531	$34,685	$34,675	$28,647
Investment in executive aircraft from which capital gain considered other revenue	68	23	—	—	—	—	—	—
Total recognized investment	$12,419	$23,223	$29,187	$28,233	$30,531	$34,685	$34,675	$28,647

1 Derived from Appendix C Supplement of Bureau Counsel's Brief to the Board.
2 Flood loss excluded from cash operating expenses as a casualty loss.
3 Variance results from decreases in break-even need and from elimination of working capital in excess of three months cash operating expenses.
4 1953 fixed investment from Appendix F of Bureau Counsel's Brief to the Board.
5 Examiner's Report did not recompute pilot strike investment.
6 See Appendix 4 for method of computation.

COMM-DC-10552

B424

(13192)

PAN AMERICAN — ATLANTIC DIVISION

Transatlantic Final Mail Rate Case

Adjustments to Break-Even Need and Summary of Total Mail Pay

(In thousands)

	1946	1947	1948	1949	1950	1951	1952	1953	Total
Break-even need per Examiner's Report	$ 2,387	$ 4,329	$ 7,686	$10,956	$10,212	$ 6,850	$ 7,124	$ 8,180[1]	$57,724
Adjustments related to stipulation between PAA and Bureau Counsel:									
Indirect maintenance related to engine maintenance adjustment				$ —42	$ —33				$ —75
Additional engine trucking expense—maintenance ferry flights					9	17			39
Allowance for vacation expense accruals	$ 308	$ 19	$ 28	48	10	$ 13 —7	$ 100		506
Adjustments to Examiner's break-even need by the Board:									
Underutilization B-377[2]						1	1	$ —17	—15
Underutilization L-49[2]						1	1	—7	—5
Excess capacity—comparable area[3]				9					9
Excess capacity—New York—Paris		15	—8	—18	—10		—88		—88
All cargo service—before selling expense adjustment[4]		5	8				—28		—49
—selling expense adjustment[4]									
Undercollections[4]				—7	—7	—10			18
Amortization of additional selling expense in A.O.A. merger costs[5]									—24
Selling expense—reversal of Examiner's offset of commission income and of additional allowance in 4th quarter 1950[6]					6	25	25	25	81
Non-divisional income (see Appendix 8)	—380	—389	—156	—82	—331	—138	—126		—787
Depreciation related to excess book value of A.O.A. assets over PAA purchase price				—117	—324	—410	—568	—668	—3,012
Reversal of Examiner's yield adjustment[3]					28	68	31	3	130
Excess need (See Appendix 7)			1,313	1,295	760	2,923	2,135		8,426
Return premium—aircraft hull insurance[7]				—2,863		—651			—3,514
Reduction of German income and other tax accruals[7]								—245	—245
Officers salaries and expenses								—144	—144
Contributions and other expenses not allowable for rate purposes								—8	—8
Total adjustments [9]	$ —72	$ —350	$ 1,185	$—1,768	$ 56	$ 1,815	$ 1,483	—26 $—1,087	—26 $ 1,262
Adjusted break-even need	$ 2,315	$ 3,979	$ 8,871	$ 9,188	$10,268	$ 8,665	$ 8,607	$ 7,093	$58,986
7% return on investment[8]	1,496	1,721	2,169	2,551	3,335	3,854[9]	4,141	4,258	23,525
Provision for actual income taxes paid:									
Atlantic Division	686	—	1,587	—	—	816	1,195	1,000[10]	5,284
Other Divisions			365	—223	—910	—49	—	—	—817
Total mail pay awarded before tax allowance on additional mail pay	$ 4,497	$ 5,700	$12,942	$11,516	$12,963	$13,286	$13,943	$12,351	$86,928

COMM-DC-10559

PAN AMERICAN — ATLANTIC DIVISION

Transatlantic Final Mail Rate Case

Adjustments to Break-Even Need and Summary of Total Mail Pay

(In thousands)

	1946	1947	1948	1949	1950	1951	1952	1953	Total
Temporary mail pay received	$ 5,624	$ 6,726	$12,285	$ 9,708	$10,735	$13,686	$12,629	$12,266	$83,659
Additional or excess (-) mail pay before additional tax allowance	$-1,127	$-1,026	$ 657	$ 1,808	$ 1,958	$ —400	$ 1,814	$ 85	$ 3,269
Tax on additional mail pay at tax rate of 52%[11]	—	—	—	338	2,121	—438	1,423	92	3,541
Total additional or excess (-) mail pay after additional tax allowance	$-1,127	$-1,026	$ 657	$ 2,146	$ 4,079	$ —838	$ 2,737	$ 177	$ 6,810
Total mail pay after additional tax allowance	$ 4,497	$ 5,700	$12,942	$11,854	$14,814	$12,858	$15,366	$12,443	$90,469

[1] Represents break-even need in Appendix J of Bureau Counsel's Brief to Board. Adjustments to 1953 break-even need are based upon the same principles underlying Board findings for prior years.

[2] Adjustment in accordance with PAA Stipulation II.

[3] Additional adjustment to amount in Examiner's Report. Examiner reversed Bureau Counsel's proposed disallowance for excess capacity in order to include as part of the over-all issue of excess need. However, the amount should have been $659,000, excluding the Bermuda adjustment, instead of $650,000.

[4] This adjustment is based on stipulation between Pan American and Bureau Counsel as to appropriate amount of disallowance, assuming that the Board rejects carrier's claims regarding selling expense.

[5] In addition to reversing Examiner's finding on commission income, this adjustment corrects amount of additional selling expense found reasonable for the fourth quarter of 1950. It was intended that an additional $124,000 be recognized as part of the cost of the AOA merger in addition to $200,000 recommended by Bureau Counsel. However, the carrier was allowed $324,000 over Bureau Counsel's adjustment.

[6] Examiner's yield adjustment was related to the issue of excess need, which has been found by the Board to have existed in the years 1949 and 1951. The reduction is due in large part to agreement between Pan American and Bureau Counsel set forth in PAA Stipulation II, filed subsequent to the issuance of the Examiner's Report.

[7] 1953 surplus adjustments per Form 41 Report.

[8] See Appendix 9 for adjustments to investment.

[9] Includes $103,000 return on working capital for LAD in 1951 agreed by the parties to be provided in this proceeding.

[10] Atlantic Division prorate of system income tax is in accordance with material submitted by Pan American in connection with offset issue, revised to reflect allocation of non-divisional income to Atlantic Division only.

[11] Should the effective tax rate be changed at the time the offset phase of this proceeding is decided, the additional tax payable in accordance with Internal Revenue Ruling 169 should be recomputed at the effective rate. The additional tax provision is distributed for administrative purposes to the most recent years for which additional mail pay is awarded.

B426

(13194)

13195

Appendix 7

PAN AMERICAN — ATLANTIC DIVISION
Transatlantic Final Mail Rate Case
Computation of PAA Excess Need
Years 1949 and 1951

	(000) 1949	1951
TWA - Int'l Div. Break-Even Need		
Operating break-even need per PAA Stip. II, App. B	$ 3,221	$ 1,085
Adjustment by Board to eliminate accrual to flood loss reserve (flood loss of $620,000 in 1951 excluded for purposes of this computation)	—19	—19
Increase in foreign mail credit in all-cargo service	183	—
Adjusted operating break-even need	$ 3,385	$ 1,066
Add: Applicable non-operating items	2,448	412
Reallocation adjustments— operating expense	166	365
nonoperating expense	44	100
Adjusted break-even need	$ 6,043	$ 1,943
Standard revenue ton-miles	39,197	52,412
Break-even need per revenue ton-mile	15.42¢	3.71¢
PAA-Atlantic Division		
Standard revenue ton-miles Transatlantic-Europe-Asia Sector	34,978	53,838
Break-even need based on TWA's need per standard revenue ton-mile	$ 5,392	$ 1,997
Break-even need for non-comparable sectors (same as Appendix B (Revised) to PAA Stip. II except decrease in U.S.-Africa freight rev. by $131,000)	2,399	2,920
Nonoperating items by sectors (same as App. B (Revised))	94	—72
Break-even need on uniform basis with TWA before allowance for special factors	$ 7,885	$ 4,845
Adjusted break-even need before elimination of excess need	$12,139	$ 9,413
Variance of "uniform" need from "adjusted" need	$ 4,254	$ 4,568
Allowance for special factors: PAA foreign mail revenue deficiency	—489	—451
Higher aircraft operating expenses after revenue offset	—902	—3,466
Excess need to be disallowed	$ 2,863	$ 651

PAN AMERICAN WORLD AIRWAYS, INC.

Transatlantic Final Mail Rate Case

Summary of Dividend and Interest Income and Profit on Sale of Stock Related to Affiliated and Associated Companies[1]

(000)

	Total All Companies		Total of Companies with Income Over 7%[2]			
	Total Dividends and Interest	Net After Taxes	Total Dividends and Interest	Net After Taxes	Recorded Investment	Allowance for 7% Return
1946	$ 513	$ 309	$ 63	$ 39	$1,630	$114
1947	754	441	94	56	1,435	101
1948	708	412	210	126	1,254	88
1949	266	159	154	92	1,254	88
1950	812	460	339	196	1,309	92
1951	855	408	380	187	1,309	92
1952	945	610	617	462	1,309	92
1953	876	585	424	381	1,309	92
Total	$5,729	$3,384	$2,281	$1,539		$759

	Net Income Related to Affiliated and Associated Companies						
	Net After Taxes	Profit on Stock Sales	Total	Other Non-Div. Income Considered Other Revenue[3]	Total Non-Div. Income	7% Return on Affiliated and Assoc. Companies Investment	Net Non-Div. Income
1946	$ 39	$274	$ 313	$ 104	$ 417	$114	$ 303
1947	56	257	313	127	440	101	339
1948	126	—	126	82	208	88	120
1949	92	—	92	70	162	88	74
1950	126	—	196	256	452	92	360
1951	187	—	187	474	661	92	569
1952	462	9	471	225	696	92	604
1953	381	74	455	381	836	92	744
Total 1946-1953	$1,539	$614	$2,153	$1,719	$3,872	$759	$3,113

[1] Based upon data in PAA Exhibit 121, Appendix D for the period 1946-1952. Data with respect to Panagra and the year 1953 are obtained from Form 41 Reports and PAA Stipulation I.

[2] Companies and income included are: Aerovias Venezolanas $ 43; Cia Mexicana 140; Airgraphs, Ltd. 15; Panagra $435; Cia PAA Argentina 54; Middle East Airlines 93

[3] From Exhibit BC-139 3rd Revised.

B428

(13196)

(13197)

PAN AMERICAN — ATLANTIC DIVISION

Transatlantic Final Mail Rate Case

Non-Divisional Income and Expense

Computation of Earnings in Excess of 7% after taxes on the Recorded Value of Investment in Affiliated and Associated Companies Stocks, Advances, and Non-Current Notes Receivable

(000)

Year 1953	Investment Record 12-31-53	Dividends and Interest	Net After Taxes @52%	Yield @7%	Excess Over 7%
Aeronaves de Mexico	$ 211	$ 18	$ 9	$ 15	$ −6
*Aerovias Venezolanas	221	24	12	15	−3
Cia. Dominicana	112	—	—	8	−8
La Nica	87	1	—	6	−6
Sahsa	80	13	6	6	—
*Cia. Mexicana	523	—	—	37	−37
Panair do Brasil	211	69	33	15	18
Cia. Panamena	33	13	6	2	4
Aeropuerto de Bogota	253	—	—	18	−18
Lacsa	32	—	—	2	−2
Cubana	200	—	—	14	−14
UMCA	158	—	—	11	−11
Avianca	2,353	338	150[1]	165	−15
Grandes Hotels	237	—	—	17	−17
Intercontinental Hotels	3,206	—	—	224	−224
*Middle East Airways	65	—	—	5	−5
*Panagra	500	400	369[2]	35	334
		$876	$585	$595	$ −10

* Indicates companies with income in excess of 7% on investment over entire period 1946-1953.

[1] Reflects deduction of Columbian dividend tax estimated at $12,000.

[2] Reflects 85% credit for domestic corporation dividend.

Source: Form 41 Report.

B429

Appendix 8
Page 3 of 3

PAN AMERICAN — ATLANTIC DIVISION

Transatlantic Final Mail Rate Case

Non-Divisional Income and Expense

Panagra Earnings in Excess of 7% after Taxes on Recorded Investment

(In thousands)

Year	Investment	Dividends	Net After Taxes	Yield @7%	Excess Over 7%
1946	$500	—	—	$ 35	$—35
1947	500	—	—	35	—35
1948	500	—	—	35	—35
1949	500	—	—	35	—35
1950	500	—	—	35	—35
1951	500	—	—	35	—35
1952	500	$375	$346[1]	35	311
1953	500	400	369[1]	35	334
Total		$775	$715	$280	$ 435

[1] Reflects 85% credit for domestic corporation dividend.

PAN AMERICAN — ATLANTIC DIVISION

Transatlantic Final Mail Rate Case

Recognized Investment

(In thousands)

	1946	1947	1948	1949	1950	1951	1952	1953
Working Capital								
Cash operating expenses per Examiner's Report	$18,052	$31,581	$35,669	$39,648	$40,318	$54,885	$60,439	$64,988[1]
Adjustments to cash operating expenses related to Board findings:								
Indirect maintenance related to engine maintenance adjustment				$ −42	$ −33			
Additional engine trucking expense-maintenance ferry flights				9	17	$ 18		
Vacation expense accruals	$ 308	$ 19	$ 28	59	10	−9	$ 100	
Underutilization of L-49 aircraft—insurance					14			
Underutilization of B-377 aircraft—insurance					44	39		
All-cargo service expenses related to increase in combat credit								
All-cargo selling expense		5	118	81	21		22	
Undercollections			8					
Cash expenses allocated to nonscheduled operations				−7	−7	−10		
Reversal of selling expense adjustment	72	469	1,221	383	330	778		
Contributions and other expenses not allowable for rate purposes				−82	−391	−138	−126	
Officers salaries and expenses								$ −26
Total adjustments	$ 380	$ 493	$ 1,375	$ 401	$ 5	$ 673	$ −4	−8
Adjusted cash operating expenses	$18,432	$32,074	$37,038	$40,049	$40,323	$55,558	$60,435	$64,954
Three months cash operating expenses	4,608	8,018	9,259	10,012	10,081	13,889	15,109	16,238
Adjusted working capital included in recognized investment	4,608	8,018	8,362	5,105	10,081	13,889	15,109	14,744
Fixed Capital								
Fixed capital per Examiner's Report	$15,137	$15,137	$21,365	$30,079	$36,038	$38,066	$42,609	$44,572[2]
Adjustments:								
Increase in investment for disallowed depreciation								374
L-049 underutilization — Reduction in capitalized interest						−2	−4	
— Elimination of capitalized insurance					−4	−12	−9	
Increased selling expense capitalized as merger cost					15	105	80	
Correction to AOA property value adjustment					197	227	60	−172
Adjusted fixed capital	$15,137	$15,137	$21,365	$30,079	$36,246	$38,384	$42,736	$44,774
Total working capital and fixed capital	$19,745	$23,155	$29,727	$35,184	$46,327	$52,273	$57,845	$59,518
Investment in affiliated and associated companies included in computation of other revenue	1,630	1,435	1,254	1,254	1,309	1,309	1,309	1,309
Total recognized investment	$21,375	$24,590	$30,981	$36,438	$47,636	$53,582	$59,154	$60,827

[1] Cash operating expenses derived from Appendix J of Bureau Counsel's Brief to the Board.

[2] Fixed capital for 1953 computed as follows:

Operating property and equipment less aircraft overhaul reserves	$41,340
Investments	107
Long term prepayments	607
Deferrals	2,518
Total	$44,572

TRANS WORLD AIRLINES—INTERNATIONAL DIVISION

Transatlantic Final Mail Rate Case
TWA Future Mail Pay
(In thousands)

	Recommended by Bureau Counsel	12 Months to Sept. 30, 1954
Operating break-even need[1]	$ 2,810	$ 1,657
Adjustments to reported data:		
Adjustments for 15% residual value and built-in overhaul		—384
Contributions, entertainment and other expenses not allowable for rate purposes		—22
Executive salaries over $65,000		—16
Accrual to reserve for termination indemnities		—77
Selling expense in excess of 19.5 percent of commercial revenues		—1,417
Adjusted operating break-even need		$ —259
9 percent return on investment	2,819	2,367
Provision for Federal income tax @ 52%[2]	2,663	2,173
Total mail pay	$ 8,292	$ 4,281
Mail pay per standard revenue ton-mile (74,606,000)		5.74¢
Investment	$31,386	$26,295[3]

TRANS WORLD AIRLINES — INTERNATIONAL DIVISION

Transatlantic Final Mail Rate Case
TWA Future Mail Pay

Footnotes

[1] Break-even need recommended by Bureau Counsel is amount shown in Brief to Board. Amounts for latest period is as reported on Form 41 Reports and Company management reports filed with the Board. Although no amount has been included for nonoperating income or expense for the latter periods, it is estimated that provision for amortization of deferrals of $55,400 is offset by an equal amount of cash discount and other nonoperating income.

[2] Reflects interest expense of $361,000.

[3] Investment at 12/31/53 computed as follows:

Working Capital	
Reported system working capital	$ —748
Elimination of 75% of notes payable from current liabilities	11,006
Transfer of cash funds to current assets	4,637
Assignment of reserve for deferred taxes direct to Domestic Div.	3,070
Elimination of items directly assigned to International Division:	
Foreign mail receivables	—1,957
Nonconvertible foreign bank balances	—48
Adjusted system working capital	$15,960
Decrease in international mail pay to 12/31/53	—171
System working capital adjusted for mail pay	$15,789
Allocation to International Division (31.04%)	4,901
Add: Foreign mail receivables	1,957
Nonconvertible foreign bank balances	48
International future year working capital	6,906
Fixed Capital	
Allocation by TWA to International Division at 12/31/53	$17,743
Depreciation adjustments	1,219
Capitalized interest	258
Unamortized deferrals	169
Total fixed capital	$19,389
Total investment	$26,295

PAN AMERICAN — ATLANTIC DIVISION

Transatlantic Final Mail Rate Case
PAA Future Mail Pay
(In thousands)

Break-Even Need

TWA adjusted break-even need for 12 months ended 9/30/54	$ —259
Standard revenue ton-miles	74,606
Break-even need per revenue ton-mile	—0.347¢
Standard revenue ton-miles estimated for PAA for the No. Atlantic-Europe-Asia Area for 12 months ended 9/30/54[1]	75,887
Break-even need for PAA's Comparable Area	$ —263
Break-even need for Non-Comparable Areas[2]	1,593
Total break-even need for Atlantic Division	$ 1,330

Investment and Return

TWA investment (See Appendix 10)	$26,295
Investment per standard revenue ton-mile	35.25¢
PAA standard revenue ton-miles in Comparable Area	75,887
PAA investment for Comparable Area	$26,750
PAA investment for Non-Comparable Area[3]	12,963
Total investment Atlantic Division	$39,713
9 percent return on investment:	
Comparable Area	$ 2,407
Non-Comparable Areas	1,167
Total	$ 3,574

Provision for Federal Income Taxes @ 52%

Comparable Area (after deduction of $367,000 interest)	$ 2,210
Non-Comparable Areas (after deduction of $210,000 interest)	1,037
	$ 3,247

Summary

	Total Atlantic Division	Comparable Area	Non-Comparable Areas
Break-even need	$1,330	$ —263	$1,593
9% return on investment	3,574	2,407	1,167
Provision for income taxes	3,247	2,210	1,037
Total mail pay	$8,151	$ 4,354	$3,797
Per std. revenue ton-mile	8.15¢	5.74¢	15.77¢

PAN AMERICAN — ATLANTIC DIVISION
Transatlantic Final Mail Rate Case
PAA Future Mail Pay
Footnotes

[1] Standard revenue ton-miles computed as follows:

	(000)		
	Comparable Area	Non-Comparable Areas	Total Division
Bureau Counsel's 1953 forecast	67,498	21,425	88,923
Percent of total	75.91%	24.09%	100.00%
Reported revenue ton-miles in scheduled passenger service-standard* distributed to areas at forecast percentage	75,887	24,082	99,969

*Standards used: 1st class 215 lbs. per passenger
Tourist 200 lbs. per passenger

[2] Allocation of break-even need to Non-Comparable Areas:

	Comparable Area	Non-Comparable Areas	Total Division
Operating break-even need forecast for 1953	$4,065	$1,914	$5,979
Percent of total	67.99%	32.01%	100.00%
Reported operating break-even need 12 months to 9/30/54			$5,734
Adjustments:			
Amortization of deferred charges			−526
Excess of adjusted net book value of AOA assets over PAA purchase price			−55
Selling expense in excess of 19.5% of commercial revenues			−430
Officers salaries and expenses not allowable for rate purposes			−28
Contributions and other expenses not allowable for rate purposes			−7
Adjusted operating break-even need			$4,678
Reported cash discount income			−29
Break-even need to be allocated			$4,649
Allocation to Areas at forecast percentage	$3,161	$1,488	
Amortization of deferrals as forecast by Bureau Counsel		105	
Total break-even need		$1,593	

PAN AMERICAN — ATLANTIC DIVISION

Transatlantic Final Mail Rate Case
PAA Future Mail Pay

Footnotes—(Cont'd)

---

[a] Allocation of investment as of 12/31/53 to Non-Comparable Areas:

Working Capital	
System working capital as adjusted by PAA at 12/31/53	$35,966
Decrease in AOA mail pay included in working capital	—526
Increase in PAA mail pay	3,576
Adjusted system working capital	$39,016
Allocation to Atlantic Division (34.182%)	13,336
Percent applicable to Non-Comparable Areas (based on same ratio of cash operating expenses as in Bureau Counsel's Brief to Examiner, Appendix CC)	23.44%
Amount to Non-Comparable Areas	$ 3,126
Fixed Capital	
Operating property and equipment — net of depreciation and aircraft overhaul reserve	$36,063
Investments in operating affiliates	104
Long term prepayments	605
Sub-total	$36,772
Allocation to non-comparable Areas (based on ratio forecast by Bureau Counsel — 25.94%)	9,539
Unamortized deferrals at 12/31/53	$ 1,610
Allocation of deferrals to Non-Comparable Areas (based on forecast by Bureau Counsel — 18.51%)	298
Total fixed capital allocated to Non-Comparable Areas	$ 9,837
Total Non-Comparable Areas investment	$12,963

Transatlantic Final Mail Rate Case
Administrative Allocation of Mail Pay[1]

American Overseas Airlines, Inc.

Period	Amount
Semi-annually:	
First half 1946	$ 913,000
Second " "	913,000
First " 1947	1,912,000
Second " "	1,912,000
First " 1948	1,765,500
Second " "	1,765,500
First " 1949	2,951,500
Second " "	2,951,500
First " 1950	4,834,633
Third quarter 1950	2,188,367

Pan American World Airways, Inc.

Semi-annually:	
First half 1946	$2,248,500
Second " "	2,248,500
First " 1947	2,850,000
Second " "	2,850,000
First " 1948	6,471,000
Second " "	6,471,000
First " 1949	5,927,000
Second " "	5,927,000
First " 1950	7,407,000
Second " "	7,407,000
First " 1951	6,426,500
Second " "	6,426,500
First " 1952	7,683,000
Second " "	7,683,000
First " 1953	6,221,500
Third quarter 1953	3,110,750
Monthly:	
October 1953	1,036,917
November 1953	1,036,916
December 1953	1,036,917

[1] Except where otherwise indicated, the amount applicable to quarters is one-half the amount for semi-annual periods.

Transatlantic Final Mail Rate Case
Administrative Allocation of Mail Pay[1]

Trans World Airlines, Inc.

Period	Amount
Semi-annually:	
First half 1946 (From February 5)	$1,497,668
Second " "	1,887,332
First " 1947	3,720,500
Second " "	3,720,500
First " 1948	5,240,500
Second " "	5,240,500
First " 1949	3,816,500
Second " "	3,816,500
First " 1950	4,248,000
Second " "	4,248,000
First " 1951	3,133,500
Second " "	3,133,500
First " 1952	2,400,000
Second " "	2,400,000
First " 1953	562,777
Third quarter 1953	281,389
Monthly:	
October 1953	328,825[2]
November 1953	351,115[2]
December 1953	702,894[2]

2 Equivalent to service rate of 85 cents times the monthly U.S. mail ton-miles.

(15106)

15106

E-10117

UNITED STATES OF AMERICA

CIVIL AERONAUTICS BOARD

WASHINGTON, D. C.

Served: March 23, 1956

DOCKET No. 1706 *et al*

REOPENED TRANSATLANTIC FINAL MAIL RATE CASE

Decided: March 23, 1956

The fair and reasonable rate of compensation for American Overseas Airlines, Inc., for the period January 1, 1946, through September 25, 1950, is $22,013,000, an increase of $4,947,000 over amounts received pursuant to temporary rate orders.

The need of Trans World Airlines, Inc., for mail compensation for the period February 5, 1946, through December 31, 1953, is reduced by $4,183,000 on the basis of earnings of its domestic operations for the same period.

The fair and reasonable rate of mail compensation for Trans World Airlines, Inc., for the period February 5, 1946, through December 31, 1953, for its international operations after offset of excess earnings from its domestic operations is $43,534,000, a decrease of $7,561,000 from amounts received pursuant to temporary rate orders.

The need of Pan American World Airways, Inc., for mail compensation for its Atlantic Division for the period January 1, 1946, through December 31, 1953, is reduced

by $6,186,000 on the basis of the earnings of its Pacific, Alaska and Latin American Divisions for the same period.

The fair and reasonable rate of mail compensation for Pan American World Airways, Inc., for the operations of its Atlantic Division for the period January 1, 1946, through December 31, 1953, after offset of excess earnings from other Divisions, is $79,784,000, a decrease of $3,875,000 from amounts received pursuant to temporary rate orders.

The rates of the three petitioners for periods prior to January 1, 1954, are subject to upward or downward adjustment to reflect ultimate tax consequences of mail pay awards.

15107

The fair and reasonable mail rate for Pan American World Airways, Inc., for its Atlantic Division operations for calendar 1954 is the rate fixed by Order No. E-9530, August 30, 1954, subject to such adjustments as may be required under the Chicago and Southern decision of the Supreme Court.

APPEARANCES:

HENRY J. FRIENDLY and ELIHU SCHOTT for Pan American World Airways, Inc., and American Overseas Airlines, Inc.

GEORGE A. SPATER, CARL S. ROWE and NAN C. SOWERWINE for Trans World Airlines, Inc.

ABE McGREGOR GOFF, FREDERICK BATRUS and EUGENE J. BRAHM for the Postmaster General.

MILTON H. SHAPIRO and ARTHUR H. SIMMS for the Bureau of Air Operations.

(15108)

15108

OPINION

BY THE BOARD:

We now have submitted to us for final decision the last remaining phase of the *Transatlantic Final Mail Rate* case, Docket No. 1706, *et al.*, involving the final rates of mail compensation for American Overseas Airlines, Inc., (AOA) from January 1, 1946 forward; for the transatlantic operations of Pan American World Airways, Inc., (PAA) from January 1, 1946 forward; and for the international operations of Trans World Airlines, Inc. (TWA) from February 5, 1946 forward. By previous decisions in this docket we have made a determination of the need of AOA and of PAA and TWA for their transatlantic operations considered alone. (Order No. E-8833, December 20, 1954, Order No. E-9530, August 30, 1955.)

Our first concern here is with the so-called "offset" problem—the question whether the operations of PAA and TWA, other than transatlantic, may have produced earnings during the review period[1] in excess of the needs of such operations which are available to reduce the subsidy need of the respective transatlantic operations. Pursuant to our order reopening the record and after proper notice, hearings on the "offset" questions were held before Examiner Ralph L. Wiser who rendered his Initial Decision on No-

---

1 For reasons explained hereinafter, for both carriers the review periods considered in this Opinion end December 31, 1953. With this closing date, the review periods for each carrier, as determined by our Opinion of September 29, 1954 (Order No. E-8672) and June 7, 1955 (Order No. E-9282), cover the time periods indicated below:

TWA—Domestic Division	February 5, 1946 to March 13, 1947
	January 1, 1951 to December 31, 1953
PAA—Latin American Division (LAD)	January 1, 1953 to December 31, 1953
Pacific Division	January 1, 1951 to December 31, 1953
Alaska Division	July 1, 1951 to December 31, 1953

vember 21, 1955. The Examiner found that PAA's Latin American, Pacific and Alaska Divisions, had produced

15109

earnings of $13,490,000 in excess of the needs of those divisions and that such earnings were available to reduce the subsidy need of PAA's Atlantic division. Similarly, the Examiner found that TWA's domestic operations produced earnings of $8,715,000 in excess of domestic need which were available to reduce the subsidy need of TWA's international operations.

Exception to various findings were taken by PAA, TWA and Bureau Counsel and supporting briefs were submitted.[2] We have heard oral argument and the case is submitted for our decision. Upon consideration of the evidence of the record, we adopt as our own, except as modified herein, the findings and conclusions of the Examiner's Initial Decision.

Our second concern here is to fix final rates for the three carriers involved. Essentially what this requires is merely a consolidation of our findings on the offset questions with those made in earlier phases of the proceeding. We will, therefore, first discuss the offset questions and then consider the problems of fixing final rates.

PAA Earnings—Pacific, Alaska and LAD

The Examiner found that PAA had net earnings before taxes totalling $33,024,000 from its Pacific, Alaska and Latin American Divisions during the period under review. Of the total adjustments and disallowances recommended by Bureau Counsel amounting to $2,911,000, issue was taken by PAA with respect to only three items: LAD DC-3 maintenance expense in 1953, involving $133,000; LAD selling

[2] The Postmaster General filed no exceptions or brief but participated in oral argument, supporting the general position of Bureau Counsel.

expense in 1953, involving $595,000; and capitalized interest affecting the need of LAD and Pacific in both 1952 and 1953, involving $12,000. The Examiner ruled against PAA on the selling expense question but held in the carrier's favor with respect to DC-3 maintenance and capitalized interest.

DC-3 Maintenance Expense

Bureau Counsel challenged the level of LAD DC-3 maintenance expense for

15110

1953, contending that the average expense of $44.97 per hour should be reduced to $25.00 per hour, resulting in a total disallowance of $133,000. Without deciding whether the expense level was excessive, the Examiner found that with the inclusion of $361,000 in profits from outside work performed at the Brownsville maintenance base as other revenue, the allegedly excessive cost of DC-3 maintenance, the major part of which was performed at that base, does not burden the mail rate and should not be disallowed.

Bureau Counsel contends that the $361,000 profit figure was substantially overstated so that, in fact, the excess expense did burden the rate. Noting that the investment in the Brownsville facility was included in the LAD rate base, Bureau Counsel argues that the other revenue actually obtained from the non-transport operations at Brownsville was well below $361,000. He suggests that if there were an allocation of an appropriate portion of the LAD return and taxes, after including a pro rata share of system working capital in investment attributable to Brownsville, the other revenue would shrink to less than $58,000. It is further argued that the profit would shrink even more if there were a full allocation of system and division overhead, and if investment were increased to account for spare

parts and assemblies contributed to the non-transport work performed at Brownsville.

The Examiner rejected the proposed allocation of working capital on the grounds that PAA's system working capital was substantially below the maximum allowable limit and that the balance of the adjustments would not bring the $361,000 profit below the $133,000 alleged excess expense. We find it unnecessary to pass upon the working capital issue reached by the Examiner.

15111

Included in Bureau Counsel's adjustments is a tax allocation of $158,000, computed by applying the 52% tax rate to the $146,000 in return he assigns to Brownsville. As noted in the margin, however, the effective LAD tax rate is 34%.[3] After adjustment of the tax allocation, the profit clearly exceeds the excessive expense.[4] Consequently, under the particular facts here involved, we will accept the Examiner's conclusion that there should be no disallowance of maintenance expense.

3 LAD Return on Investment after offset		$4,001,000
LAD Tax—1953	$3,681,000	
Tax savings on LAD excess earnings (computed)	$1,591,000	
Net LAD Tax		$2,090,000
Total		$6,091,000
Effective Tax Rate		34.31%

4 With respect to system and divisional overhead that Bureau Counsel would assign to Brownsville, the record shows that the total would be insignificant, consisting of a very small percentage of the salaries of two or three executives and their staffs. As to FESPA, the record shows that LAD does not require an inventory devoted to the requirements of its non-transport work at Brownsville.

(15111, 15112)

LAD Selling Expense

The Examiner held that $595,000 of LAD's total 1953 selling expense of $11,401,000[5] was excessive and should be disallowed. He found that PAA had not made the required showing to justify the upward departure from the level we had set as reasonable in our prior opinions and orders fixing LAD rates, including the rate effective January 1, 1953.[6] In those cases we had concluded that LAD selling expense, after exclusion of selling expense related to all cargo, foreign mail and non-scheduled revenues, should not exceed 19% of remaining commercial revenues (revenues classified as passenger, express and freight, excess baggage and other transportation).[7] PAA excepted to the Examiner's

conclusion, reiterating on brief to the Board, the following arguments addressed to the Examiner: (1) that PAA's selling expense is not subject to scrutiny when incurred under a closed final rate and (2) that the carrier's total expense was not excessive when measured against the actual expense of the transatlantic carriers or the other Latin American carriers.

We believe the record compels the conclusion that LAD selling expense was excessive. It is no answer to compare LAD expense with the higher expense level of the transatlantic carriers, since we have held the transatlantic expense to be excessive also. We find no justification in the

5 This amount is equivalent to 19.62% of *total* commercial revenues.

6 Pan American World Airways, LAD Mail Rates, Order No. E-7441, June 5, 1953, finalized by Order No. E-7495, June 19, 1953; Order No. E-7650, August 19, 1953, finalized by Order No. E-7673, September 1, 1953.

7 PAA objected to the segregation of all cargo, foreign mail and non-scheduled expense and revenues but no reason was suggested for such a departure from the method we have previously used with LAD. See footnote 6, *supra*.

fact that the selling expense of other Latin American carriers exceeds that of LAD, the strongest carrier in the area. Neither is it material that LAD was operating under a closed "future" rate, inasmuch as we have already held that we must screen LAD operations under the conventional standards of honest, economical and efficient management. Nevertheless, though we are not persuaded by PAA's contentions, by going beyond them to examine the conditions prevailing in 1953, we find that the normal circumstances under which we established the 19% benchmark for LAD selling expense did not prevail in 1953. Although LAD maintained its marked superiority over other American Flag carriers, as measured by relevant characteristics, it suffered a sharp cut-back in capacity in that year in complying with the Board's previous findings regarding its excess capacity.

To place the LAD operations in the context of the times it must be recalled that in 1953 the Board fixed rates for LAD's operations from 1947 through 1951 and from January 1, 1953 forward.[8] In our evaluation of results for the past period, we concluded that PAA had operated a substantial amount

15113

of excess capacity which was maintained throughout 1952. Early in 1953 PAA took steps to make a sharp capacity cutback in the areas, such as the New York-Rio de Janeiro-Buenos Aires segment, where we had disallowed capacity. We commended the carrier for this action in our Statement fixing the future rate effective January 1, 1953, and do so again in light of the favorable effect the action had on LAD subsidy requirements.

A review of LAD's 1953 operations reveals that the cut-

8 See note 6, *supra*.

back exceeded the carrier's initial estimate, as indicated by the following figures:

LAD Standard Available Seat Miles
(000)

1952 Actual	1,308,000
PAA's 1953 Forecast	1,246,000
1953 Actual	1,214,000

The total does not indicate the magnitude of the cut-back in areas where capacity had previously been excessive. During 1953 the carrier found it necessary to increase capacity over some of the stronger segments, such as New York-San Juan, and justifiably so in view of its load factors. Thus while system capacity, in standard available seat-miles, dropped approximately 7 percent in 1953 over 1952, with the exclusion of New York-San Juan results, the estimated capacity cut-back for the balance of the system exceeded 15 percent.

It would be unrealistic to expect PAA to be able to increase its traffic—as we had forecast PAA would—while at the same time reducing capacity so extensively, without a selling effort more intensive than normal. Moreover, although Division figures reflect a 5 percent increase in traffic in 1953 over 1952, closer analysis shows

that the increase represented a 20% advance in New York-San Juan traffic coupled with a 5% decline in the balance of the system,[9] a reversal of the post-war trend for the balance of the system. Under the impact of such adverse

[9] LAD Revenue Passenger Miles (000)

	Division Total	New York-San Juan	Remainder
1952	760,787	284,557	476,230
1953	796,318	341,349	454,969

circumstances we are unable to conclude that it was unreasonable for PAA to exceed temporarily the normal 19% selling expense level.

As we noted at the outset, however, we think that the comparative evidence relied on by the Examiner establishes that PAA's actual expense was excessive. While we are willing to concede some increase over the normal, we must still decide the measure of reasonableness. The amount actually expended in 1953 was only $40,000 below the 1952 level which we have found nureasonably high in fixing the 1953 rate, and was more than a half-million dollars in excess of the expense we forecast for 1953. Looking back over the past period 1947-51, we see that before the disallowance of excess selling expense, the carrier's average selling expense was only 19.35% of appropriate commercial revenues and its high, 19.96%,[10] as opposed to the 20.13% claimed by PAA for 1953.

Realizing that the issue is largely one of judgment, in the absence of evidence that would enable us to assess the relationship between the higher expense level and the traffic obtained, and in view of the relative position of LAD as compared with the Atlantic Division, we see no basis for allowing an increase over the normal LAD level greater than the additional half-percentange point allowed PAA's Atlantic Division, or 19.5% of appropriate revenues. This level allows PAA $273,000 or 2.5%, more than the normal 19% level and a total 1953 selling expense of $11,060,000 which

15115

is substantially greater than the reported total expense of any prior year except 1952.[11]

10 Order No. E-7441, June 5, 1953, page 33.

11 In arriving at the 19.5% ratio for LAD we have been influenced by the fact that the selling expense requirement of the New York-San Juan local service, considered alone, would be substantially below the Division

(15115)

Capitalized Interest

During the 1951-1953 period both carriers maintained substantial advance deposits ("equipment purchase funds") with various aircraft manufacturers pursuant to contracts for the purchase of aircraft. Well established rate-making doctrine requires the exclusion of these deposits from the carriers' rate bases, but permits capitalization of constructive interest on the deposits, to be amortized over the service life of the aircraft involved. Since the 1947 decision in the *Pan American-Transatlantic Mail Rate Case*, 8 C.A.B. 267, the Board has computed the amount of interest on such funds in the following manner:

(a) To the extent the deposits were not in excess of the carriers total debt, by applying the average interest rate paid by the carrier on its outstanding debt to the amount of the deposit; and

(b) To the extent the deposits exceeded total debt, by applying a 5% rate to the excess.

During the reopened phase of this proceeding the carriers have both maintained that the Board should apply the actual average interest rate only to deposits in fact derived from debt, applying the 5% rate to all deposits proved to be derived from equity sources. Evidence was adduced showing the derivation of the funds in the instant case, evidence which was not contradicted. After a review of precedent, the Examiner concluded that the carrier's

---

requirement since that service is more akin to the domestic operations of the Big Four carriers. Accordingly, the 19.5% Division allowance in effect provides the balance of the system a ratio above that level. Since the actual ratio of the smaller U. S. carriers in the area was only 20.54% in 1953, the 19.5% allowance is clearly adequate for LAD.

claim was one of the first impression[12] and represented an equitable refinement on the policy stated in prior Board Opinions. He went on to recommend further clarification of the Board's policy in this regard.

Despite Bureau Counsel's cogent exposition of the principles underlying the formula used hitherto, we are firmly convinced that reexamination of the problem of interest on equipment purchase funds is required. The formula employed to date was developed in the immediate postwar period under far different circumstances than prevail in the industry today.[13] At that time the cyclical pattern of equipment replacement and fleet expansion was not so apparent; the bulk of the industry was then subsidized; it was in financial straits at the very time many carriers were engaged in the purchase and integration of whole fleets of new equipment; and furthermore, the capital structure of many carriers appeared then to include an excessive portion of debt. All of these factors, as well as others, played an important role in the original evaluation of the problem. With the marked change of conditions in the interim, it is possible that our previous policy is no longer satisfactory to accomplish its intended objectives. We shall therefore direct our staff to make an appropriate study of the problem to enable us to reconsider our previous policy.

Meanwhile, in our opinion the Examiner has satisfactorily resolved the problem on the record developed here. If it is granted that we will recognize the deposits as equity funds in some cases, we are unable to say that we should

---

12 We note that the Examiner overlooked the claim of TWA which we disposed of in the transatlantic phase of the proceeding, Order No. E-0530, August 30, 1955. That ruling is discussed in footnote *16, infra*.

13 See Letter of then Chairman O'Connell to all Airline Presidents, March 3, 1949, cited in *Pan American World Airways, Transpacific Mail Rates*, 14 C.A.B. 818, 827 (1951).

not recognize the source of equipment deposits in any case where it

15117

is proved that they were unmistakably and necessarily derived from equity rather than debt funds; the recognition of actual source is logically consistent with the objective stated in our prior opinions[14] of recognizing the higher cost of equity capital. Within the framework of our policy as expressed to date, the Examiner's conclusion appears to be the most equitable disposition of the problem as it is raised by the record in this case.

PAA Net Earnings—Pacific, Alaska and LAD

There is no issue concerning the taxes allocable to the earnings recognized or, except as affected by the expense issues discussed above, the investment allocable to the Pacific, Alaska and LAD operations. After subtracting the taxes by PAA, amounting to $14,394,000 from the $32,751,000 in earnings recognized herein, PAA has net earnings of $18,357,000,[14a] equivalent to a 15.08 percent return on recognized investment. In a succeeding section we will consider what portion of this total profit was needed by PAA.

TWA DOMESTIC EARNINGS

The Examiner found that TWA's net domestic earnings before taxes for the review period were $32,032,000,[15] after adjustments and disallowances totalling $11,036,000. The adjustments and disallowances were, in large part,

---

14 See, e.g., *Pan American World Airways, Transatlantic Mail Rate Case*, 8 C.A.B. 267, 286 (1947).

14a A summary of the results of the Examiner's findings as to PAA's total earnings, as modified by the Board, appears in Appendix No. 1.

15 This figure, as well as others used herein that include results for 1946 and 1947, includes losses suffered during the periods 1-1-46 to 2-4-46 and 3-14-47 to 3-31-47, which are not part of the review period. Appropriate adjustment is made to eliminate results for these periods in Appendix No. 2, attached.

either conceded by TWA, subject to an overall objection to "screening" or determined by the Board itself in prior opinions, leaving issues involving $3,754,000 to be decided by the Examiner. The Examiner decided all of these,

15118

except the issue relating to capitalized interest,[16] adversely to TWA. We adopt his findings and conclusions in their entirety. The few words we add hereafter merely reinforce his conclusions. A summary of the Examiner's findings appears as Appendix No. 2.

(1) Together with its claim that the domestic loss from its 1946 pilot's strike cannot and should not be disallowed, TWA has argued that charitable contributions and other expenditures[17] normally disallowed in a subsidy rate case cannot be challenged in this case where we are determining the need of its unsubsidized domestic operations. The carrier maintains that our position on strike losses and the other expenses has been predicated on "policy" grounds, a basis which is said to be proscribed by the Supreme Court's decision in *Western Air Lines* v. *Summerfield*, 347 U. S. 67 (1954). Though the Examiner disposed of the strike loss question, he did not specifically advert to this argument of TWA or the other "policy" disallowances.

We agree with Bureau Counsel that TWA's theory is untenable. In the first place, even were it true that losses and expenses of the type involved would be recognized in

16 Our decision on reconsideration in the transatlantic phase of the case disposed of a similar issue adversely to the carrier. Though the issue was basically the same as the one in the instant phase, we see no reason to modify our disposition of the transatlantic phase of the case at this late date, especially since TWA took no exception to our decision insofar as it affected the capitalized interest issue. Our views on the general problem of reconsidering, at this time, issues finally disposed of in earlier decisions, are set out hereafter.

17 These include memberships, excessive executive salaries, entertainment expense, financing fees and the cost of operating an executive aircraft.

fixing the rate of an unsubsidized carrier, TWA was a subsidized carrier when viewed as a whole and we are here determining its subsidy entitlement. Moreover, TWA's argument is but another aspect of its larger argument that "screening" of its reported earnings is neither permissible nor appropriate in this case, an argument that we rejected in our

Opinions of September 29, 1954 (Order No. E-8672) and June 7, 1955 (Order No. E-9282). Finally, it is apparent that the disallowance of strike losses, charitable contributions and other items comprehended by TWA's exceptions are not proscribed by the Supreme Court's decisions in either *Western* or the *Chicago & Southern Case*. True, we have a "policy" regarding these expenditures—but it is the "policy" of precedent, a "policy" which simply represents an accumulation of consistent rulings that subsidy is not needed under the Act to meet such expenses.

(2) TWA has excepted to the Examiner's ruling that the entire profit on the sale of certain equipment in the review period should be included as revenue in that period. The carrier denies that the sale of the aircraft actually produced a profit. The record shows that certain aircraft, almost fully depreciated prior to the review period, were sold during the period for a total amount in excess of depreciated original cost but below original cost. TWA maintains that the book profit (excess over depreciated original cost) is the result of erroneously excessive depreciation charges made in the past which should now be corrected by assigning the book profit pro rata to the years (primarily prior to the review period) in which depreciation was charged. The Examiner, properly held that the granting of TWA's request would result in a double recovery of the cost of the aircraft: once through the expense charges

for depreciation and again through the profit from the sale. TWA responds by arguing that to attribute the profit to the review period twice overstates earnings: first, because the review period bears little of the depreciation or investment (return) cost of the aircraft, and second because the entire depreciation adjustment (profit) is attributed to years in which little depreciation was charged.

15120

It is axiomatic in rate making that the costs of assets can be recovered but once through the rate. Having recovered the cost of these aircraft through depreciation charges, TWA has no claim to again recover that cost by excluding the sale profit from revenues. Despite its alleged "loss", TWA has obviously lost nothing by employing a conservative service life. On the contrary, the carrier obtains greater investment protection by the rapid recovery permitted and is enabled to reinvest the recovered cost which thereby reappears in the rate base either as working capital or new equipment. The anomaly of TWA's claim lies in the fact that we have permitted the use of conservative service lives for depreciation purposes as an incentive to replace fleets with more modern aircraft. It would be a perversion of this promotional objective to accede to TWA's argument.

(3) TWA has levelled a broadside attack on certain tax allowance rulings in the case,[18] charging that the rulings are designed to give the Government the benefit of all tax refunds while leaving all tax expense to be borne by the carrier. The single ruling directly involved in this phase of the case is the Examiner's holding that the tax refund obtained in 1946 by a carry-back of 1946 losses must be

18 The "deferred tax" issue; the 1946 tax refund issue; and the issue first raised on brief to the Board, concerning the tax effect of the refund of excess mail pay. This latter issue is dealt with hereinafter.

included in its entirety and not only in proportion to the amount of losses that we have recognized for rate purposes.

There are several fallacies in TWA's argument. Foremost is the assumption that we will provide subsidy for tax allowance in excess of the total tax liability incurred by the carrier on its earnings. So too is the implicit assumption that in this case we are including tax refunds without meeting TWA's full tax liability.

15121

In fixing subsidy rates based on "need", we recognize only such taxes as the carrier will actually be obligated to pay. The purpose of allowing taxes is to assure that the carrier will in fact receive the intended return on investment that is contemplated by the rate. To accomplish this end we include all taxes paid or payable in a rate period, any refunds obtained on carry-back losses, and any additional tax or reduction in tax related to any retroactive increase or decrease in mail compensation, leaving the carrier with the net return intended. TWA argues, from a simplified hypothetical example, that our policy would entail the recapture of a tax refund even in an instance where the carrier suffered an overall loss and, therefore, had no tax liability. That problem is not presented here since it is apparent that for the review period here involved, TWA will have had an overall liability for taxes that has been provided for in determining its rate. Once we have met its total tax liability, TWA has no cause for complaint.

TWA Net Earnings

There has been no question as to allowable investment except as investment is affected by the expenses allowed and disallowed. Deducting the total domestic taxes paid by TWA, amounting to $9,792,000, from the domestic earnings of $32,032,000 leaves TWA with a return on

recognized investment of 9.85%. In a succeeding section we will consider what portion of these earnings was needed by TWA.

Reconsideration of Previous Decisions Adverse to TWA

In its exceptions to the Initial Decision and on brief to the Board, TWA has re-argued several questions that the Board had decided in previous phases of this case.[19] On all of these issues, the Board has previously received

petitions for reconsideration and affirmed its original disposition of the issues. Having been fully heard and decided previously, the issues were not properly in the case at its present stage. TWA's method of addressing its re-argument to the Board by including the issues in exceptions to the Initial Decision on "offset" is a thinly veiled endeavor to escape our rule prohibiting successive petitions for reconsideration.

Orderly administration requires an end to litigation. In no case is this principle more dramatically illustrated than here. This case was first submitted to the Board for decision over 18 months ago. In its various aspects, the proceeding has been pending before the Board itself almost continuously since then. We have issued six separate opin-

---

19 In our opinion of September 20, 1954, order No. E-8672, reconsideration denied, order No. E-9282, June 7, 1955, we decided that TWA's domestic operations in the review period had to be "screened" under Section 406 and that losses in the period January 1 to February 4, 1946 could not be considered. In our opinion of December 20, 1954, order No. E-8833; reconsideration denied order No. E-9530, August 30, 1955, we passed upon issues related to the increase in residual values of aircraft and the 1946 tax refund. On July 28, 1955, order No. E-9441, reconsideration denied, order No. E-9598, September 28, 1955, we ruled on the "deferred tax" issue. In addition, although raised before the examiner, the issues as to TWA's 1953 earnings were disposed of by our December 20, 1954 and August 30, 1955 opinions.

ions in the interim, and have had to evaluate evidence and argument on some of the most complex questions ever presented to the Board for decision. The principles evolved from our consideration of this case have taken their place in the framework of our administration of Section 406 of the Act. In these circumstances, the policy against repeated reconsideration must be applied to permit the prompt and effective discharge of our regulatory responsibilities. This is not to suggest that we may not modify decisions where new evidence so dictates. But there is no new evidence or changed circumstances here; in fact, TWA fails even to allege changed circumstances except in regard to the "deferred tax" issue.[20] Accordingly, the Board finds that no further consideration

should be given to the issues previously decided and that TWA's exceptions and argument, which are in effect requests for reconsideration, should be denied.[21]

---

20 TWA cites a recent decision of the Court of Appeals for the District of Columbia in *City of Detroit* v. *FPC*, decided December 15, 1955 [24 Law Week 2266], rendered subsequent to our ruling on TWA's "deferred tax" claim, as a new circumstance supporting its view. There is nothing in the decision of the Court of Appeals inconsistent with our decision which, as our opinion indicated, turned on the "need" provisions of Section 406, a rate statute far different from the one before the Court. Our decision was reached with full knowledge of the FPC practice which was approved by the Court in the *Detroit* case.

21 In a separate statement attached hereto, Members Gurney and Denny favor reconsideration and reversal of the Board's earlier decision on the "deferred tax" issue. Chairman Rizley has participated in this proceeding solely with respect to the "deferred tax" question, and joins with Member Adams in rejecting TWA's request to reconsider this matter. Accordingly, TWA's proposal herein for reconsideration of the "deferred tax" decision embraced by Order No. E-9441, dated July 28, 1955 (reconsideration denied), Order No. E-9558, dated September 28, 1955, fails by an equally divided Board.

Rate of Return

One of the Board's prime objectives in reopening the record in this case was to take evidence concerning ". . . the need of the other division or divisions [of TWA and PAA] when operating under a final prospective rate to retain higher rates of return than would be established in a rate for a subsidy carrier." (Order No. E-8672, September 29, 1954.) The resolution of this issue will determine whether there were any "excess" earnings available to reduce the need for subsidy to support the transatlantic operations of the two carriers.

The Examiner has found that the other divisions of these carriers had no need for returns higher than would normally be established for subsidized carriers of the same class and, more specifically, found that earnings of TWA's domestic division above an 8% return on investment and earnings of PAA's other international divisions above a 10% return on investment were in excess of the needs of those divisions. He held that the Board's findings in the transatlantic phase of this case, as well as its findings in numerous other cases decided during the review period, sustained the reasonableness of the 8% and 10% figures and found that nothing adduced by the carriers showed that they would be unable to attract capital with such earnings. He rejected the carriers' view that the reasonableness of their earnings should be measured against long term results extending beyond the review period, finding that the Board's opinion in the *General Passenger Fare Investigation Case*[22] did not permit subsidy need to be calculated so as to permit excessive earnings in good times to tide carriers over possible

---

22 Order No. E-7376, dated May 14, 1953.

future bad times, and concluded that if the risk of loss was on the carriers in their non-atlantic operations, the return levels customarily employed in fixing future rates were more appropriate than the lower level used for past periods where losses are underwritten.

Both airline parties excepted to these findings, maintaining that they need all earnings in fact obtained; Bureau Counsel and the Postmaster General support the Examiner's conclusions. We agree with and adopt the Examiner's findings on the rate of return question; however, because of the importance of the issue and the nature of the carriers' arguments, we consider it desirable to set forth our reasoning in detail.

Both TWA and PAA addressed themselves in major part to establishing what the customary rate of return has been for carriers of their classes. PAA concedes that a 10% rate of return on investment is adequate for its operations but contends that it must obtain this return on an actual basis and on an average, over an extended period; further, PAA maintains that the Board's prior decisions and practice evince an intent that a 10% return be realized over an extended period, at least by international carriers. TWA has developed a similar analysis to show that the return the Board has considered reasonable for domestic carriers—especially domestic carriers of the Big Four group in which TWA maintains it belongs—has been substantially greater than 8%. Both carriers urge, in effect, that the reasonableness of their earnings must be measured over an extended period broader than the review period, apparently over the historical span of the Civil Aeronautics Act. If review is extended sufficiently beyond the review period, the sum of their earnings, they claim, falls within the bounds of reasonableness. The main prop supporting their analysis is their interpretation of our

opinion in the *General Passenger Fare Investigation Case*, Order No. E-7376, May 14, 1953. We shall deal first with

15125

these contentions going to the fundamentals of our rate-making process and turn then to the evidence of the specific needs of the two carriers.

I

Nothing that we have said in the above-cited opinion permits or compels the result these carriers would have us reach in this case. To go all the way back to 1938 in establishing rates in this proceeding would exceed all reasonable bounds of establishing a representative period or a cycle, and would obviously be contrary to the substantial economic changes in air transportation affecting these carriers. To take in profits or make up losses in years prior to the time the rates were challenged would be equally inappropriate. Our opinion in the 1944 *Chicago and Southern Case* on a similar plea established our interpretation of Section 406 of the Act:

> "The mail rate provisions of the Civil Aeronautics Act do not call for what would be in effect a revision of historical earnings so as to reimburse the carrier for inadequate profits received in the past; those provisions require the establishment of present and future rates which will enable the carrier under honest, economical and efficient management to discharge its public service obligations as specified in the Act. The statutory policy is not remedial of past inadequacies; it is instrumental of present and future accomplishment." 4 C.A.B. 419, 420-421.

The past period involved here, for which we have fixed rates on a virtual cost plus basis, is certainly long enough and representative enough. We are satisfied that the rates

fixed for such past period satisfy the "need" of each carrier under Section 406. For the future period, we have fixed, or are in the process of fixing, rates that are in complete accord with the standards of Section 406, including the consideration of the "need" provision thereof. We fail to see by what general public utility rate-making standards, or standards that may be

peculiar to our Act, we would be justified in awarding compensation in excess of such sums.

II

TWA calls our attention to a roster of opinions, including virtually all service mail rate cases decided from 1942 to the present, in which the Board has uniformly forecast earnings in excess of 10%, generally in excess of 20% and as high as 46%. Those forecasts have no relevance to need for subsidy. In all of those cases the Board was fixing *service* mail rates on the basis of cost, determining a reasonable rate of return only on investment devoted to the mail service which, since World War II, has been 8% domestically. The return referred to in such cases was an overall return anticipated from commercial rates and fares as well as mail rates. The overall return was cited only as proof of self-sufficiency and was not the subject of inquiry in those cases.

Both carriers also cite a series of cases decided in 1942-43 in which the Board allowed carriers to retain earnings in excess of 8% accumulated during a period when proceedings were pending for the determination of final rates.[23] We believe that a careful reading of the opinions in these cases

[23] Pan American-Grace Airways, Mail Rates, 3 C.A.B. 550 (1942); Pan American Airways, LAD Rate Case, 3 C.A.B. 657 (1942); Eastern Air Lines, Mail Rate Proceeding, 3 C.A.B. 733 (1942); American Air Lines, Mail Rate Proceeding, 3 C.A.B. 770 (1942).

will reveal substantial differences in facts and circumstances from the cases before us now. We do not find the essential rationale of those cases applicable here, nor have we found occasion to apply such rationale to any other situation in the post-war period.[24] Since we are convinced, however,

that there is no justification for awarding additional compensation here, we would have no hesitancy in overruling these prior cases if their rationale were applicable here. It may also be that these earlier cases are in conflict with the Supreme Court's decision in the *Western* Case, *supra,* and the *Chicago and Southern* Case.

Our attention is also directed to cases where we have allegedly fixed rates for subsidy carriers intended to produce returns in excess of 8 percent. TWA points to a series of cases involving Continental Air Lines in which sliding scale rates were fixed that permitted earnings above and below 8% with variations in load factor. PAA makes an argument in the same vein. However, the adoption of an incentive formula such as a sliding scale does not indicate a determination that the higher return possible under such a formula is in our opinion a reasonable return any more than does the adoption of a flat rate which also may result in earnings higher than forecast.[25] Indeed, the sliding scale formula is a

---

24 The *Big Four Case* (American Airlines, *et al.*, Mail Rates, 14 C.A.B. 558, 565) decided in 1951 was the single instance brought to our attention of a post-war case where we allowed a subsidized carrier other than a local service carrier, a return higher than the customary level. That instance, however, involved the establishment of a uniform group rate for the Big Four. The principle is not applicable in the instant case.

25 For discussions of some of the multiple objectives underlying our use of such formulas, see *Capital Airlines, Mail Rates,* 14 C.A.B. 623 (1951) and *Continental Air Lines, Mail Rates,* 8 C.A.B. 825, 839-43 (1947). Of course it would be possible to eliminate entirely the profit increment possible under such rates, but to do so would destroy the incentive to minimize subsidy. The incentive is also intended to avoid increased *dependence* on subsidy.

safety valve to limit the profit of the carrier in the event that traffic exceeds that forecast; the flat rate formula lacks this safety factor. In any event, it is apparent from a full reading of the Statements in each case where we have used the sliding scale rate (except those involving local service lines for which we have established a different return level) that we have forecast a reasonable return of not more than 8% for domestic and 10% for international carriers. The concurrent use of incentive formulas of various types in no way alters the significance of those findings.

A related facet of the arguments of both carriers is that higher returns attained by subsidy carriers, especially in recent years, under final rates that were subject to reopening by the Board, are evidence of Board policy recognizing that earnings above the 8% and 10% level are reasonable.[26] Any such inference from our inaction is not valid, especially in the face of our numerous decisions during the same period finding the 8% and 10% returns to

be reasonable. As Bureau Counsel has pointed out, the Board's determination *not* to reopen a rate is necessarily prospective—a judgment that a rate which may have produced excessive earnings in the recent past will not do so in the future. That this judgment may have in some instances proved to be imperfect does not permit the inference that the return subsequently earned was deemed reasonable.[27]

---

26 We have consistently held that the earnings of other carriers are not a measure of "need". Continental Air Lines, Mail Rates, 6 C.A.B. 97, 104 (1944); Chicago and Southern Air Lines, Mail Rates, 1943 4 C.A.B. 419, 421 (1944).

27 Apropos of the statement in the text, it is significant that the high returns earned by the subsidized carriers to which TWA and PAA point were earned primarily in the Korean War period which produced an in-

III

TWA urges that in addition its case involves special considerations which establish that it is ". . . entitled to earn as much as comparable carriers." Since its domestic operations were conducted under a service or compensatory rate, TWA concludes that it was subject to the same risks as other service rate carriers and therefore entitled to retain its entire earnings. Since its compensatory rate was a "group" rate, uniform for all the Big Four carriers which were found to be comparable for rate purposes, TWA claims a right to earnings as high as the other Big Four carriers earned.

The Examiner properly rejected this contention. As a result of the Supreme Court's *Chicago and Southern* decision, we are obliged to test TWA's need in the light of its system operations. Though we may fix a service rate for one of the divisions of a carrier, when we find that a carrier requires subsidy for its operations as a whole, it is a subsidized carrier and must be treated as such. TWA would apparently distinguish the case of a carrier, such as itself (with only one of its two divisions requiring subsidy), from the *Chicago and Southern* case where both of the separate divisions required subsidy. The Supreme Court's opinion permits no distinction: the test is the carrier as a whole.

15130

So long as TWA was covered by the terms of Section 406, it was entitled to subsidy support at any time its return fell below 8%—putting it in the same position as any other subsidized carrier. The importance of this protection is illustrated by TWA's own experience: TWA's domestic operations were under a group service rate during the 1946-

crease in volume that was, to say the least, unanticipated. At the same time, the equipment programs of several of these carriers as well as the trends of cost in general had led the industry itself, as well as the Board, to expect narrower profit margins.

47 period involved in this case; yet with the filing of its petition for subsidy on March 14, 1947 it again received subsidy in substantial amounts for the period through December 31, 1950. It is true that this subsidy was also granted under a group rate which provided TWA a return at the bottom of the range of four carriers, but the fact that it received a percentage return lower than the other carriers in the group was due, as the Board specifically found, to TWA's failure to meet the statutory standards of economical and efficient management. The risk of inefficiency is one that must always fall on the individual carrier and cannot be the basis for a higher return.

Finally we are met with the contention from TWA that it requires earnings comparable to those of other Big Four carriers to maintain its competitive position in relation to them. Following this line TWA argues that without comparable earnings it will be unable ". . . to experiment with advanced types of aircraft, or to place larger orders, or to buy more expensive models, . . . to provide fancier service, . . . to experiment with excursion fares or to sustain a general fare reduction." The argument is not supported by the evidence of record and is reminiscent of those rejected by the Supreme Court when it decided the *Chicago and Southern* case.

15131

It was a direct consequence of the Court's reversal of our earlier policy in that case that we ordered the record in this proceeding reopened. We find, however, that there is no evidence beyond the mere statement, that by virtue of the reduction of its earnings and the subsidy status in which it is placed, TWA will be unable to introduce new equipment, to make or meet fare reductions or to accomplish any of the other progressive ends it mentions. To the contrary, our experience has been that the very carriers here involved,

despite their allegedly lower historical earnings, have been in the forefront with more modern equipment and experimental fare reductions. Where reasonable, we have in the past recognized the costs of such endeavors in fixing subsidy rates for these as well as other subsidized carriers.[28] Without a showing that higher profits are in fact required to support continued advance, the Courts' mandate precludes us from granting such higher earnings merely with the hope that greater prosperity will beget progress.

IV

Bureau Counsel rested his case on the return requirements of the two carriers largely on the record developed and our findings in the earlier transatlantic phase of this case, and, in addition, on the rates of return we have regularly held reasonable and applied during the review period to operations of the types conducted by PAA and TWA.[29] The record amply supports Bureau Counsel's recommendation and the findings of the Examiner.[30] Despite

15132

the invitation extended to the carriers by our order reopening the record, to produce facts on which we might predicate a finding of need for earnings different from the rate customarily provided, the evidence the carriers have come forward with has been relatively meagre. Thus from

---

28 See also our Statement of Policy regarding fare experimentation: Section 399.15, Policy Statements, Regulations Part 399, May 25, 1955.

29 A sampling of opinions in which we have held reasonable the return levels recommended by Bureau Counsel for the respective carriers appears in the Examiner's Initial Decision at page 27.

30 The Postmaster General has concurred in this result on the theory that we are bound to abide by the same percentage return for the operations involved that we had forecast as reasonable in fixing the future rates that were in effect during the periods we are reviewing. The conclusions we reach make it unnecessary for us to pass upon this theory.

an evidentiary standpoint we are left virtually in the same place we were at the conclusion of the transatlantic phase of the case insofar as the return question is concerned.[31] We will limit our discussion, therefore, to a consideration of the different circumstances affecting the periods and operations involved and their effect on what we have already found as to the return required by these carriers to attract capital on fair terms.

Analytically, the problem here is to evaluate the risk carried under the final future type rates that were in effect for the operations under review. Though past in time and free of the uncertainties inherent in future rate making, the review period for the operations involved carried with it the risk of loss always encountered under a future type rate. It appears that under *TWA* v. *CAB*, 336 U.S. 601 (1949), we would have had no authority to increase the transatlantic rates of TWA and PAA had the earnings of their other divisions been inadequate. This being so, despite the right to petition for increased rates for these other divisions, the carriers had a material risk of loss.[32] In this light we see no cause to allow these carriers less for bearing that future-type risk than we have customarily found necessary to compensate carriers in the same class for that risk in cases decided during the review period. For domestic operations such as were conducted by

---

31 We fail to see the significance of the distinction drawn between "reasonable rates" and rates that are "not unreasonable". Apparently the carriers are urging us to employ the judicial review test of "range of reasonableness", and we obtain no guidance from the "range of reasonableness" rationale in our endeavor to find "need".

32 It is because PAA bore the risk of loss that it was entitled to a future type rate of return in the rate effective January 1, 1954. Having obtained such a rate, PAA's claim that its Atlantic Division earnings for 1954 were inadequate and should be considered in the 1954 offset proceedings appears inconsistent. See text at note 53, *infra*.

TWA this would be 8%. For PAA, conducting international operations, the rate should be 10%, that used for international operations throughout the review period and until December 31, 1953, after which we reduced the international return to reflect the lesser risks of the more mature, well-established, international industry.

Essentially PAA does not challenge these findings. It takes a different tack, namely that the Board must apply the 10% return figure to long term results and with special consideration for PAA's multi-division structure. These basic claims are bolstered with evidence of PAA's current financial condition and its future capital needs. We have already met its first contention,[33] *supra*, and we do not see that its multi-division structure is reason for according it special consideration.

The carrier contends that adoption of the Examiner's conclusion will work a discrimination against multi-division carriers. Essentially the argument is that because of the complexity of its rate cases, PAA will generally have one of its four divisions on an open rate; that it will, therefore, never earn more than 10% after offset of "excess" earnings and will never have the opportunity provided single division carriers, to make up losses it may suffer under the divisional final rates. We do not anticipate that in the future we will fix subsidy rates for different divisions of a single carrier seriatim,[34] where each such division requires subsidy; thus, the problem should not arise henceforth.

---

33 *Supra*, pp. 18-22.

34 We recently fixed rates for PAA on a system basis effective January 1, 1955, as we had previously done for Braniff and Delta. See Order No. E-9889, December 30, 1955 (PAA); Order Nos. E-9841, E-9842, December 13, 1955 (Delta) and Order Nos. E-9711, E-9712, November 3, 1955 (Braniff). Of other multi-division carriers, Northwest and TWA have compensatory rates for all divisions and Colonial's rate is currently open system wide.

Should we in the future change our present policy of fixing rates on a system basis, there will be time enough for PAA

15134

to seek special consideration. As for the review period, PAA has not suffered any such losses overall; moreover we are allowing PAA a 3 point greater return to compensate it for bearing the risk of such losses. On the present record, therefore, and at the present time, we see no substance to PAA's argument.

The balance of PAA's case becomes an attack on the return we found reasonable for PAA in the transatlantic phase of the case. In point of fact, the evidence of its current financial position is the same evidence we considered in the transatlantic phase, brought up to date with some more recent figures and with the jet commitment factor added.

PAA points out that its stock is still selling at somewhat below book value (after climbing to that level for a short time during the summer of 1955) and that little of it is held by institutional investors. But, given a record of expense disallowances such as PAA has had in the recent past—disallowances required by statute—its stock prices would almost of necessity fall below book value. The same record undoubtedly influences the institutional investor. The logical inference is not, however, that the return allowed is inadequate. To leave PAA with earnings in excess of the return we have found reasonable in order to maintain the market value of its stock would be to shift the burden of the disallowances back to subsidy—to indirectly reimburse the carrier for what we have directly found not reimburseable.[35] A similar argument from PAA was disposed of by Examiner Radcliffe in the transatlantic

[35] For the same reasons we give no weight to TWA's evidence of its reported low earned surplus and low ratio of current assets to current liabilities.

phase of this case and affirmed by us there;[36] we see no reason for changing our conclusion now.

15135

The carriers have joined in urging the Board to leave them with their excess earnings to enable them to meet their forecast jet equipment commitments, which have arisen since our earlier consideration of this case. We are of course seriously concerned with the financing problem the industry faces in acquiring this equipment and are cognizant of the need for a favorable climate for the potential investor. But the Board has no warrant from Congress under Section 406 to supply these carriers with capital funds from subsidy. The claims of PAA and TWA we construe to be tantamount to a request for a grant of the amount of their excess earnings to be used for equipment purchases.

Moreover, the evidence does not establish that PAA will be left, even after its earnings are reduced by our action here, in a situation where it will not be able to attract capital on fair terms. Aside from what we have already discussed, the only real evidence of PAA's ability to raise capital is a recent debt flotation. If that loan (of $60 million at 3¾ percent payable over a period of years from 1966) does not positively establish its ability to attract capital on fair terms, it certainly is evidence of this ability which we do not find contradicted by anything else in the record.

TWA's response to Bureau Counsel's recommended 8 percent return is essentially a challenge to the efficacy of the cost of capital method as applied to the airline industry. We rejected this claim in the transatlantic phase of the case and see no reason for reiterating those conclusions here. TWA goes on to argue that any reduction in actual earnings will increase its cost of capital, making the evi-

36 Order No. E-8833, December 20, 1954, App. A, p. 97-98.

dence of Big Four capital costs that we relied on in the transatlantic phase inapplicable.[37] As in the case of PAA, despite

15136

TWA's relatively poor record of actual earnings,[38] the evidence does not establish that it has had or will have difficulty in raising needed capital. Its witness conceded that TWA's stock was relatively attractive in its category. TWA emphasizes that this category covered "speculative" airline stocks as opposed to the "good quality" category in which American and Eastern fall. It is true that TWA's classification is less favorable, for it reflects TWA's past earnings record. Nevertheless, we still consider the characterization as a favorable one, especially relative to the number of other airlines falling below TWA in the listing. If not definite proof of TWA's ability to finance, we think this evidence tends to preclude the opposite inference and we find it uncontradicted by other evidence adduced by TWA.[39]

Our conclusion is not altered by TWA's contention that a higher cost of capital would result for TWA from a reduction in its earnings to the 8 percent level. Although TWA's earnings over an extended period have been lower than other Big Four carriers, it offers no evidence that

---

37 TWA also suggests that after eliminating the international factor in the cost of capital data we used in the transatlantic phase and "rounding off" as we did there, the domestic return indicated is 8.4 percent. Our judgment to use a 9 percent rate internationally involved far more than a mere "rounding off" of cost of capital data. As we stated in our Opinion, moreover, it was our judgment that the data indicated a domestic return requirement of 8 percent.

38 Also, as in the case of PAA, TWA's "actual" earnings history reflects the substantial disallowances we have been obliged to make not only here but in the past in fixing its international rate as well as its domestic rate for the 1947-1950 period.

39 Despite TWA's past earnings record the market price of its stock has in recent months varied at a level somewhat above book value.

this has resulted in a higher cost of capital for TWA, nor do we read the earnings price data available as supporting TWA's theory.

On the evidence of record, we are satisfied that an overall return of approximately 8 percent for TWA is sufficient to meet the investor's demand. Under honest, economical, and efficient management this produces a return in excess of 13 percent on common equity[40] which, in the light of the evidence, clearly meets the cost of common stock.

15137

As we have indicated in the foregoing, both carriers have relied heavily on their current financial positions and their potential capital needs in arguing this case. We are here concerned, however, with their needs in the 1946 to 1953 period rather than later years. The ability of those carriers to raise and carry the tremendous capital needs foretold will be determined largely by earnings in years subsequent to those we are considering.

It is noteworthy that effective January 1, 1954 (or for over 2 years) TWA's entire system has had the benefit of service rates for both domestic and international divisions and is, therefore, free from the current restrictions on earnings imposed on subsidy carriers. Effective January 1, 1955, PAA's entire international system has been placed on final future subsidy rates under which it has been provided reasonable opportunity to earn a forecast 9 percent rate of return. Nothing alleged by either carrier, no prophecy of its witnesses in this case, and nothing known to the Board suggests that these rates, even as affected by our action in this case, will be inadequate to enable them to

40 TWA argues that after adjusting the 8 percent overall return to reflect disallowances the 13.06 percent return on common stock produced by an 8 percent overall return would fall below 8.7 percent. As we indicated earlier, we cannot fix a return here that will negate the disallowances required under the Act.

finance their equipment programs. If they should become inadequate, the burden is on the carriers to tell us so by petitioning for increased future rates.

We have considered all the facts of record and the arguments of PAA and TWA as to the rate of return they required and, except insofar as we have indicated herein, we find them without merit. In so doing we repeat that much of the content of their cases duplicates what they submitted and we disposed of in the transatlantic phase of the case. On the basis of all the evidence of record, we find that TWA's domestic operations for the review period required earnings of no more than 8 percent on recognized investment and that PAA required earnings for the review period of 10 percent on recognized Pacific, Alaska and LAD investment. Accordingly, we find that TWA's international subsidy need is reduced by $4,183,000 and PAA's by $6,186,000 (both exclusive of tax effects) for the period through December 31, 1953.

15138

Determination of Rates

In our Opinion on reconsideration in the transatlantic phase of this case (Order No. E-9530, August 30, 1955) we set forth our findings and conclusions on the then existing record as to the subsidy need of the three carrier-petitioners for their transatlantic operations. We also fixed rates for the carriers that, except for the rate for TWA effective January 1, 1954, were subject to adjustment on the basis of findings and conclusions to be made in the instant offset phase of the case. Having now completed action on the reopened record, we are prepared to make a further determination of the mail pay needs of the carriers.

Before we proceed to the actual calculation of the rates,

however, we are faced with a question as to the proper tax allowance to be included in the final mail rates. Pursuant to Revenue Ruling 169 of 1953, retroactive increases or decreases in mail pay are reported by the carriers in the year of payment rather than the year to which the retroactive change applies. In calculating the additional mail pay due for transatlantic operations alone in the August 30, 1955 Opinion we employed the ordinary corporate tax rate effective for 1955; the Examiner, who rendered his Initial Decision in 1955 used the same rate. As the law presently stands, however, the rate applicable to calendar year taxpayers in 1956 is somewhat lower.

Both Bureau Counsel and TWA have recommended that we should employ the tax rate in effect for the year in which mail pay is refunded in computing excess mail pay. In addition, they recommend that we should provide for the eventuality that the effective tax rate for the year of refund may be different from that now in the statute for 1956. Since the modification of compensation that will result from our order is only for years for which "past period" rates

15139

have been fixed, we will accept these recommendations as being consistent with our actual tax policy. We do not agree with TWA, however, that the applicable tax rate will be that for the year in which all appeals from our order are exhausted. Our order will be immediately effective and the obligations created thereby will fall due immediately. There is no indication that either TWA or PAA will fail to realize taxable income in 1956 in excess of the refund required of each. Consequently, the 1956 tax rate will be applicable. If our order were to be reversed on appeal in a later year so as to require a change in the total mail pay, any change in tax consequences would be considered in the remanded proceeding. Accord-

ingly, we shall employ the 48.25% tax rate applicable to the three carriers for 1956 in computing their mail pay, subject to an appropriate condition that will adjust the mail pay set forth for each herein with any statutory change in the effective corporate income tax rate for 1956.

In its brief to the Board and at oral argument TWA has contended, for the first time and without prior notice to other parties, that if the "deferred tax" ruling adverse to TWA stands,[41] the Board cannot include the "tax savings" to be realized upon the refund of excess mail pay in the amount of such excess mail pay. Both "deferred taxes" and "tax savings" are 1956 items,[42] according to TWA, and the exclusion of the "deferred tax" precludes inclusion of the "tax savings" in the rate for the past period. We disagree. Inclusion of the tax savings in the total mail pay is but another aspect of the "actual tax" policy. Their inclusion is necessary to reflect the net taxes payable by TWA on the earnings

of the review period.[43] "Deferred taxes" on the contrary, are not taxes at all, but represent an hypothetical expense designed to normalize income. To allow "deferred taxes" would be to provide TWA total mail pay for the review period in excess of its need; to exclude the "tax savings" would have the same effect.

American Overseas Airlines, Inc.

In our decision on reconsideration in the transatlantic phase of the case (Order No. E-9530, August 30, 1955) we

41 Order No. E-9441, July 28, 1955, reconsideration denied, Order No. E-9598, September 28, 1955.

42 TWA states that a portion of the taxes "deferred" by its rapid amortization certificates will fall due in 1956.

43 See, e.g., National Airlines, Mail Rates, Order No. E-9769, November 23, 1955, page 23, finalized by Order No. E-9815, December 7, 1955.

found that American Overseas Airlines had a total mail pay need of $22,399,000 for the period from January 1, 1946 to September 25, 1950 consisting of a break even need of $14,139,000, a return of $5,005,000 and a tax allowance of $3,255,000. To preclude overpayment of PAA, AOA's successor by merger, our order stayed the additional $5,333,000 mail pay due AOA. Our order also provided for subsequent adjustment of the total AOA mail pay to provide for any increase or decrease in federal income taxes payable on the additional mail pay. While information then available indicated that the additional taxes on the AOA mail pay would be an obligation of PAA subject to the ordinary corporate income tax rate, we entertained some doubts as to ultimate tax treatment that would be accorded in view of a ruling handed down by the Internal Revenue Service in a case of similar nature. We directed PAA and Bureau Counsel to file a request for ruling with the Internal Revenue Service so that we would have the benefit of the Internal Revenue Service views in determining the tax allowance necessary on the additional mail pay.

It appears that a final ruling has not yet been obtained from Internal Revenue, but from indications available it is reasonably clear that the most

15141

favorable tax treatment will require payment of additional taxes on the total mail pay at the ordinary corporate rate in effect in the year the additional mail compensation is paid. We do not believe that payment of the AOA compensation on this assumption will entail any risk of overpayment. Accordingly, we shall compute the rate on this basis, retaining the appropriate condition permitting adjustment of the total mail pay in the event the actual tax on the additional mail pay is greater or less than our estimate.

Since the 1956 tax rate will also be applicable to the additional AOA mail pay, it is appropriate that we modify our estimate of the tax, as originally set forth in our Opinion of August 30, 1955, subject to further modification if the 1956 tax rate is subsequently revised. With the application of the currently effective 1956 tax rate, AOA's total mail pay is $22,013,000, an increase of $4,947,000 over temporary mail pay received by AOA, of which $2,387,000 is the allowance for taxes on the additional mail pay.[44] The administrative allocation of the total mail pay amount appears in Appendix No. 6 attached.

Trans World Airlines, Inc.

In our final opinion in the transatlantic case we found that TWA's need for its international operations alone for the period February 5, 1946 through December 31, 1953 was $47,340,000.[45] We have found in the instant decision that from its domestic operations during the same period TWA had earnings of $4,183,000 available to reduce international need. Accordingly, the need of

its international operations is reduced to $43,157,000, before taxes. Its net tax liability, after deducting the tax reduction that TWA will obtain on refund[46] of the excess mail

44 Since we have concurrently herewith determined PAA's "excess earnings" and issued an order that will result in refund of excess mail pay received by PAA there is no reason to continue the stay of payment on the additional mail pay due AOA.

45 Exclusive of taxes.

46 As a matter of convenience, the Board has made a net computation of taxes in fixing the rate for the transatlantic operations of TWA and PAA rather than making a separate computation of the tax savings on the excess earnings of other divisions as did the Examiner and the parties. To the extent that the refund of excess mail pay is attributable to earnings of other divisions, the tax savings are properly considered as a reduction in the total tax liability of such other divisions rather than the transatlantic operations here involved.

pay, is $377,000, bringing its international need up to $43,534,000 or $7,561,000 less than the temporary mail pay received.[47] (See Appendix No. 5.) Since, with our action here, we have given consideration to all elements going into the determination of TWA's need for the period February 5, 1946 through December 31, 1953, we may now fix a final rate for that period and the stay contained in our order of August 30, 1955 is automatically dissolved.

Of the total mail rate of $43,534,000 fixed for TWA herein $1,363,674 is attributable to the period October 1, 1953 to December 31, 1953. This latter amount is the equivalent of a service mail rate of 85 cents per mail ton mile and accordingly is payable in its entirety by the Postmaster General pursuant to Reorganization Plan 10 of 1953.

The allocation of total mail pay to periods appears in Appendix No. 6. It will be noted that for the period from January 1, 1948 to December 31, 1953 the amount allocated to each sub-period is equivalent to 85 cents per mail ton mile carried by TWA. This allocation is made for administrative purposes only and is not a rate determination. We have previously held that TWA's need must be determined for the entire period from February 5, 1946 to December 31, 1953 and a rate fixed on the basis of results for the entire period. That finding is

not altered by the administrative allocation of mail pay herein.

TWA's rate for the period on and after January 1, 1954, which was also subject to determination in this Docket, was fixed finally by Order No. E-9530, August 30, 1955 and we therefore have no further action to take with respect to periods after December 31, 1953.

---

47 This computation is predicated on the 48.25% tax rate in effect for 1956 and will be subject to adjustment in the event that tax rate is modified.

(15143, 15144)

Pan American World Airways, Inc.

In our determination in the transatlantic phase of the case we found that PAA needed $83,239,000[48] for the period January 1, 1946 through December 31, 1953 for its transatlantic operations considered alone. In the instant decision we have found that PAA has earnings in the amount of $6,186,000 from its Pacific, Alaska and Latin American Division during the same period that are available to reduce the need of its Atlantic Division. The net need of the Atlantic Division before taxes, then, is $77,053,000. After deducting from the $4,601,000 income taxes allocated to the Atlantic Division for the 1946-53 period, the $1,870,000 tax reduction that will be obtained upon refund of the excess mail pay, the total tax allowance is $2,731,000. This increases PAA's need to $79,784,000, which is $3,875,000 less than the temporary mail pay received. As in the cases of TWA and AOA, the computation of the tax allowance is predicated on the currently effective 1956 tax rate, and the mail rate we fix will be subject to adjustment in the event of a revision of the 1956 tax rate.[49]

15144

On the basis of the foregoing we are now able to fix and publish a rate for PAA's transatlantic operations for the entire period from January 1, 1946, to December 31, 1953. It will be noted that in our opinion of September 29, 1954 (order No. E-8672) we excluded the operations of

---

[48] Exclusive of taxes.

[49] In our order of August 30, 1954 (Order No. E-9530) we also made PAA's rate for the past period subject to adjustment in the event that the tax on the additional mail pay awarded AOA is greater or less than the tax we have estimated on such mail pay. We will include the same condition in the instant order. This will permit an increase or decrease in the PAA rate to reflect any actual tax consequences of the receipt by PAA as successor to AOA, of the additional mail pay awarded AOA. This relief is in line with our inclusion of the additional AOA mail pay in the determination of the PAA rate.

PAA's Latin Ameican Division for 1952 from our consideration of the need of the carrier as a whole. The rate for the 1952 LAD operations is subject to determination in another proceeding then and still pending (Docket No. 3308). Since it is clear that LAD operations will require subsidy for 1952 and since the rate will be fixed on a past period basis in the light of actual results, there will be no "excess earnings" from 1952 LAD operations; since we have considered the need of the balance of the system for that year herein, we may therefore fix a rate for the Atlantic Division for the period prior to December 31, 1953, without including any provision for subsequent adjustment for "excess earnings."

In our opinions of December 20, 1954, and August 30, 1955, we also determined the need of PAA's Atlantic Division alone for the period commencing January 1, 1954, and fixed a rate, as a basis for payment, that was subject to any adjustment required by the Board's final determination in the instant proceeding (i.e. the reopened phase of this case was instituted by order No. E-8672, September 29, 1954). Prior to hearing, however, the Examiner limited the issues in the reopened proceeding to the period prior to January 1, 1954. This action was taken at the request of PAA and with the concurrence of Bureau Counsel with the understanding between them that the issue of excess earnings available for offset against Atlantic Division subsidy for the period on and after January 1, 1954, would be considered in the then pending *Transpacific Mail Rate Case,* Docket No. 6429, or in other proceedings, and the further mutual undertsanding that the issue of the deficiency of earnings in the

Atlantic Division for the period beginning January 1, 1954,

would be considered in the same proceeding.[50] In the interim, by order No. E-9889, December 30, 1955, the Board determined final future rates effective January 1, 1955, for the Pacific and Latin American Divisions[51] and fixed a rate for the entire system. As a result of these developments, the PAA future rate fixed by our order of August 30, 1955, is involved in this proceeding only for the calendar year 1954; any adjustment to the rate for 1954 pursuant to our order of August 30, 1955, will be made on the record developed in a different proceeding in accordance with the Examiner's ruling.

It is apparently contemplated by the parties that any adjustments necessary to reflect the earnings of other Divisions (i.e. other than Atlantic) for 1954 can be made with equal facility in fixing the Pacific division rate for 1954. Should this method prove feasible, the Board will interpose no objection to reflecting all excess earnings of other divisions in the Pacific rate. We will, nevertheless, leave in force, the terms of the rate as set forth in our August 30, 1955, order to permit downward adjustment of the transatlantic rate for 1954.

We attach no significance to the understanding of the parties that the "* * * the issue of the deficiency of earnings of the Atlantic Division for the period beginning January 1, 1954 * * *" will also be considered in the *Trans-Pacific Mail Rate Case, supra,* or other proceedings. Whatever may have been intended, we wish it made abundantly clear that the Board does not deem this understanding of the parties to be controlling; our action herein

---

50 See footnote 37a, page 26, *supra.*

51 The rate for the Pacific Division was reopened effective January 1, 1954, by Order No. E-7981, December 21, 1953, and that for the Latin American Division was reopened effective December 31, 1954, by Order No. E-8869, December 31, 1954.

15146

is certainly not a concession that any inadequacy of Atlantic Division earnings will be grounds for reducing excess earnings of, or increasing the rates of, other divisions. In short, we will credit the understanding of the parties only to the extent that it recognizes PAA's right to raise an issue—a right which PAA had in the absence of the understanding.

Of the total mail pay proposed for PAA herein for the period January 1, 1946 through December 31, 1953,[52] $1,772,500, is attributable to the period October 1, 1953 through December 31, 1953. For this period, pursuant to Reorganization Plan 10 of 1953, the Postmaster General will pay PAA, for the carriage of mail, a service rate of 85 cents per mail ton mile, the rate established by Order No. E-7721, September 16, 1953. The difference between the total mail pay attributable to this period and that paid by the Postmaster General is subsidy and will be paid by the Board. With respect to the rate effective January 1, 1954, it is estimated that during calendar 1954 the rate will produce approximately $8,125,000; of this total it is estimated that service mail pay paid by the Postmaster General will be approximately $4,759,000 and the subsidy paid by the Board, approximately $3,366,000.

15147

CONCLUSION

On the basis of the foregoing findings and conclusions, we find that the fair and reasonable rates of compensation to be paid each carrier listed below for the transportation of mail by aircraft, the facilities used and useful therefore and the services connected therewith for each period listed

[52] The administrative allocation of the total mail pay for this period appears in Appendix No. 6.

below, and subject to the conditions listed below, are as follows:

A. To American Overseas Airlines, Inc., for the period January 1, 1946, through September 25, 1950, over its entire system, the sum of $22,013,000.

B. To Pan American World Airways, Inc., for operations between the points between which the carrier has been authorized to carry mail by its certificates of public convenience and necessity authorizing transatlantic operations to points in Bermuda, Europe, Africa and Asia.

1. For the period January 1, 1946, through December 31, 1953, the sum of $79,784,000.

2. For each calendar month during the calendar year 1954, in which miles designated by the Postmaster General for the transportation of mail are flown, a rate of 50.90 cents to be applied to the scheduled miles flown during the month, or 44,024 miles times the number of days in the month, whichever is the lower; provided, however, that

a. For the calendar year 1954, the amount of mail pay computed in accordance with paragraph 2 shall be reduced by the amount of $54,000; and

b. The total amount of mail compensation payable pursuant to this order for the 12 month period ended on December 31, 1954, shall be as set forth in (1) or (2) below, whichever is the higher:

(1) The amount computed in accordance with the formula above for each month in such period; or

(2) The amount computed in accordance with the applicable service mail rate or rates for each month in such period.

The scheduled miles flown shall be computed on the direct airport-to-airport mileage between the points actually served on each revenue trip operated over Pan American's authorized transatlantic routes pursuant to its flight schedules filed with the Board, including all revenue trips operated as extra sections thereto.

C. To Trans World Airlines, Inc., for operations between the points between which it has been authorized to carry mail by its certificates of public convenience and necessity other than certificates authorizing (1) interstate air transportation as defined in the Civil Aeronautics Act, and (2) air transportation between the United States and terminal points in Canada for the period February 5, 1946 through December 31, 1953, the sum of $43,534,000.

D. The compensation provided herein shall be in lieu of, and not in addition to, the mail compensation heretofore received by American Overseas Airlines, Inc., Pan American World Airways, Inc., and Trans World Airlines, Inc., for the respective services and periods covered herein; provided, however, that

(1) The compensation established herein for Pan American World Airways, Inc., American Overseas Airlines, Inc., and Trans World Airlines, Inc., for periods prior to January 1, 1954 shall be adjusted in the event of any amendment of Section 11 of the Internal Revenue Code resulting in an effective corporate income tax rate for the calendar year 1956 which is greater or less than 48.25%. Upon the effective date of any such

amendment, the amount of mail pay determined for American Overseas Airlines, Inc., herein and the amounts of mail pay determined for Trans World Airlines, Inc. and

(15149, 15150)

Pan American World Airways, Inc., shall be recomputed on the basis of the income tax rate so established.

(2) The compensation determined herein for American Overseas Airlines, Inc., and Pan American World Airways, Inc., is subject to such adjustment as may be required in the event that the actual Federal Income Tax liability of either or both such carriers with respect to the additional mail pay awarded herein to American Overseas Airlines, Inc. is greater or less than $2,387,000.

(3) The compensation determined herein for Pan American World Airways, Inc. for the calendar year 1954 is subject to such reduction for the period January 1, 1954 through December 31, 1954 as may be required by the Board's final determination in the *Transpacific Mail Rate Case,* Docket No. 6429 or other proceeding in which the need of the carrier as a whole for the period January 1, 1954 through December 31, 1954 may be determined.

An appropriate order will be entered.

Adams, Vice Chairman, concurred in the above opinion. Gurney and Denny, Members, filed the attached concurring and dissenting statement. Rizley, Chairman, participated in and concurred with the above opinion only insofar as it denies reconsideration of the Board's prior ruling denying TWA's "deferred tax" claim.

15150

STATEMENT OF MEMBERS GURNEY AND DENNY

We concur in the views expressed in the Board's opinion except insofar as further consideration is denied of TWA's request regarding "deferred taxes". In our dissenting opinion accompanying Order Nos. E-9441, dated July 28, 1955, and E-9598, dated September 28, 1955, we expressed the view that TWA's mail compensation should make ex-

press provision for "deferred taxes". While we recognize that a majority of the Board reached a contrary conclusion both in an original decision and opinion on reconsideration, we believe that sufficient new circumstances have been presented to warrant further consideration of this problem.

Our attention has been called to a recent decision of the Court of Appeals for the District of Columbia in *City of Detroit v. Federal Power Commission*, dated December 15, 1955, sustaining an order of the Federal Power Commission to the extent that such order made provision for deferred taxes in a manner similar to that urged by TWA. We believe this court action is a new matter of such importance as to justify further consideration of the deferred tax matter.

We must also emphasize that the Board has an obligation under Section 2 of the Act to encourage and develop the air transportation system properly adapted to the present and future needs of, among other things, the *national defense*. In this connection, agencies of the United States Government responsible for the national defense of our country have expressed a vital interest in the deferred tax issue in this case. On February 28, 1956, the Director of the Office of Defense Mobilization communicated with the Board, and stated as follows:

15151

> "The granting of accelerated tax amortization to encourage the acquisition of facilities deemed necessary in the interest of national defense is one of the mobilization activities for which the Office of Defense Mobilization is responsible. While it is not the desire of this office to interfere in any way with the policies and procedures of the Civil Aeronautics Board, it is necessary to bring to your attention the danger to the defense mobilization program which could result from the Board's adoption of such a conclusion.

(15151)

"You are no doubt aware that the Congress enacted the amortization provisions of the Internal Revenue Code for the purpose of encouraging the investment of private capital in facilities which are considered to be essential to the mobilization program. You are also aware that such investments are accelerated during the emergency period because of the inducement afforded by the amortization deduction. The prospects of temporary tax savings from use of the special tax amortization deduction assist greatly in financing the necessary expansion and are often reflected in the terms of the financial commitments undertaken. If the processes of rate-making nullify the benefits extended under the tax amortization statute, *there is a clear danger that the cooperation of industry in undertaking expansion necessary to national defense will not be forthcoming.* Thus private funds will not be invested in needed facilities or at least not as soon as the interests of national defense might require." (Emphasis added.)

In addition, the Board, on March 6, 1956 received a communication from the Secretary of Commerce who in commenting upon the Board's tentative decision in this matter stated:

"This method of handling the necessity certificates with regard to rate-making may result in vitiating the benefits offered to the air carriers under the accelerated amortization allowance and the expansion of the industry's capacity to meet national defense needs may not be realized."

In view of the above statements[1] pointing out the dangers of the Board's decision to the national defense, we can only conclude that the action of the Board is contrary to both the public and national interests of our country. In view of the foregoing, we here reaffirm the views expressed in our dissenting opinions in Order No. E-9441, dated July 28, 1955, and Order No. E-9598, dated September 28, 1955.

/s/ CHAN GURNEY

/s/ HARMAR D. DENNY

1 The Board has also been informed, indirectly, that the Department of Defense has similar views.

APPENDIX A

DOCKET NO. 1706 *et al.*

THE EXAMINER'S INITIAL DECISION REFERRED TO HEREIN IS NOT ATTACHED TO THIS COPY BECAUSE OF THE WIDE CIRCULATION GIVEN AT THE TIME OF ITS RELEASE. THE INITIAL DECISION IS ATTACHED TO THE ORIGINAL OF THE BOARD'S OPINION AND TO THE OFFICIAL COPIES IN THE BOARD'S FILES AND MAY BE EXAMINED THERE. IT WILL ALSO BE PRINTED AS PART OF THE OFFICIAL "CIVIL AERONAUTICS BOARD REPORTS".

Reopened Transatlantic Final Mail Rate Case
PAN AMERICAN WORLD AIRWAYS, INC.
Pacific, Alaska and Latin American Division
Earnings for offset against Atlantic Division
Mail Pay
(In thousands)

	1951		1952		1953			Total Years 1951-1953
	Pacific	Alaska (Last 6 Mos.)	Pacific	Alaska	Pacific	Alaska	LAD	
Adjusted net income before taxes[1]	$7,068	$633	$7,497	$527	$7,265	$375	$9,800	$33,165
Adjustments to net income:								
1. DC-3 total maintenance costs over $25.00 per total hour: Reversal of Disallowance	—	—	—	—	—	—	–133	–133
2. Amortizations of capitalized interest on DC-6B equipment purchase funds								
a. Reversal of allowances per Bureau Counsel's position	—	—	1	—	3	1	10	15
b. Revised allowances per opinion	—	—	–1	—	–5	–1	–16	–28
3. To reverse selling expense adjustment proposed by Examiner	—	—	—	—	—	—	–545	–545
To eliminate excess selling expense (based on 19.5%)	—	—	—	—	—	—	272	272
Total Adjustments	$—	$—	$	$—	$ –2	$—	$ –412	$ –414

[1] Appendix A, Initial Decision of Examiner Wiser.

B490

(15153)

Reopened Transatlantic Final Mail Rate Case
PAN AMERICAN WORLD AIRWAYS, INC.
Pacific, Alaska and Latin American Division
Earnings for offset against Atlantic Division
Mail Pay
(In thousands)

	1951		1952		1953			Total Years 1951-1953
	Pacific	Alaska (Last 6 Mos.)	Pacific	Alaska	Pacific	Alaska	LAD	
Adjusted net income before taxes as revised	$7,068	$633	$7,497	$527	$7,263	$375	$9,388	$32,751
Actual taxes as revised[2]	3,309	275	3,204	293	3,449	183	3,681	14,394
Adjusted profits after taxes	$3,759	$358	$4,293	$234	$3,814	$192	$5,707	$18,357
10 percent return on investment	2,481	108	2,509	228	2,568	276	4,001	12,171
Excess earnings available for offset	$1,278	$250	$1,784	$ 6	$1,246	$ –84	$1,706	$ 6,186

[2] Based on PAA Stipulation I and PAA Information Request (Revised) for 1953 and including tax effect of Havana Airport revenue adjustment.

Reopened Transatlantic Final Mail Rate Case
PAN AMERICAN — ATLANTIC DIVISION
Pacific, Alaska and Latin American Divisions — Investment
1951 - 1953
(In thousands)

	1951		1952		1953		
	Pacific	Alaska	Pacific	Alaska	Pacific	Alaska	LAD
Working capital[2]	$ 6,421	$1,392[1]	$ 5,730	$1,285	$ 4,573	$1,221	$13,632
Less: adjustments for revised earnings available for offset							
a. Reversal of Bureau Counsel adjustments	—	—	$ 2,170	$ 254	$ 3,686	$ 214	$ 1,072
b. Revised adjustments	—	—	2,170	−254	−3,684	−214	−853
Total Adjustments	$ —	$ —	$ —	$ —	$ 2	$ —	$ 219
Working capital as revised	$ 6,421	$1,392	$ 5,730	$1,285	$ 4,575	$1,221	$13,851
Fixed and other investment[2]	$18,393	$ 767	$19,355	$ 990	$21,097	$1,535	$25,129
Capitalized interest on equipment purchase funds							
a. Reversal of allowance by Bureau Counsel	—	—	$ −3	—	$ −20	$ −1	$ −52
b. Adjusted allowance	—	—	5	—	30	1	79
Total adjustments	—	—	$ 2	$ —	$ 10	$ —	$ 27
Fixed and other investment as revised	$18,393	$ 767	$19,357	$ 990	$21,107	$1,535	$26,156
Total investment as revised	$24,814	$2,159	$25,087	$2,275	$25,682	$2,756	$40,007

[1] Average investment July 1 to December 31, 1951.
[2] As recommended by Bureau Counsel on basis of his recommended expense disallowances.

B492

(15155)

Reopened Transatlantic Final Mail Rate Case

TRANS WORLD AIRLINES — INTERNATIONAL DIVISION

Earnings of Domestic Division for Offset Against International Division Mail Pay[1]

(In thousands)

	1946[2]	1st Qtr. 1947[2]	1951	1952	1953	Total 1946-53
Adjusted Net Income before Taxes	$ –5104	$ –3657	$11837	$13859	$15097	$32032
Income Taxes	–3016	—	4899	4607	3302	9792
Adjusted Profit after Taxes	$ –2088	$ –3657	$ 6938	$ 9252	$11795	$22240
8% Return on Investment	2030	548	3823	5239	6417	18057
Earnings Available for Offset	$ –4118	$ –4205	$ 3115	$ 4013	$ 5378	$ 4813

Recognized Investment for Domestic Division

(In thousands)

	1946	1947	1951	1952	1953
Working Capital	$ 3846	$ 5956	$15571	$11838	$11489
Fixed and Other Investment	24223	28776	32211	53653	68727
Total Investment	$28069	$34732	$47782	$65491	$80216

[1] See Appendix D, Initial Decision of Examiner Wiser.
[2] Adjusted to exclude net income, after taxes, for periods 1-1-46 through 2-4-46 and 3-14-47 through 3-31-47.

Appendix No. 3
Page 1 of 1

Reopened Transatlantic Final Mail Rate Case

Summary of Total Mail Pay
(In thousands)

American Overseas Airlines, Inc.

	Total
Break-even need[1]	$14,139
Return on investment[1]	5,005
Provision for taxes[2]	2,869
Total mail pay	$22,013
Temporary mail pay	17,066
Additional or excess (—) mail pay	$ 4,947

1 See appendix No. R-1, Order No. E-9530, August 30, 1955.

2 Includes income tax of $2,387,000 payable on additional mail pay pursuant to Revenue Ruling 169 of 1953 computed at the currently effective 1956 tax rate of 48.25 percent.

Appendix No. 4
Page 1 of 1

Reopened Transatlantic Final Mail Rate Case

Summary of Total Mail Pay
(In thousands)

Pan American—Atlantic Division

	Total
Breakeven need—Transatlantic Operation[1]	$ 59,694
Return on investment @ 7%—Transatlantic Operation[1]	23,545
Excess earnings available for offset (See Appendix No. 1)	—6,186
Provision for income taxes[2]	2,731
Total Mail Pay	$ 79,784
Temporary mail pay received	83,659
Additional or excess (—) mail pay	$—3,875

1 See Appendix R-6, Order No. E-9530, August 30, 1955.

2 Total taxes allocated to transatlantic operations (See App. R-6, Order No. E-9530, August 30, 1955, less tax reduction, under Revenue Ruling 169 of 1953, related to refund of excess mail pay. Tax reduction computed with currently effective 1956 tax rate of 48.25 percent.

Appendix No. 5
Page 1 of 1

Reopened Transatlantic Final Mail Rate Case

Summary of Total Mail Pay
(In thousands)

Trans World Airlines—International Division

	Total
International breakeven need[1]	$ 31,845
International return on investment @ 7%[1]	15,495
Domestic earnings available for offset (See Appendix No. 2)	—4,183
Provision for incomes taxes[2]	377
Total Mail Pay	$ 43,534
Temporary mail pay received	51,095
Additional or excess (—) mail pay	$—7,561

1 See Appendix R-3, Order No. E-9530, August 30, 1955.

2 Total taxes allocated to international operations (See Appendix R-3, Order No. E-9530, August 30, 1955) less tax reduction pursuant to Revenue Ruling 169 of 1953, related to refund of excess mail pay. Tax reduction computed with currently effective 1956 tax rate of 48.25 percent.

Appendix No. 6
Page 1 of 2

Reopened Transatlantic Final Mail Rate Case
Administrative Allocation of Mail Pay[1]

American Overseas Airlines, Inc.

Period	Amount
First half 1946	$ 913,000
Second half 1946	913,000
First half 1947	1,912,000
Second half 1947	1,912,000
First half 1948	1,767,500
Second half 1948	1,767,500
First half 1949	2,965,500
Second half 1949	2,965,500
First half 1950	4,658,000
Third quarter 1950	2,239,000
Total	$22,013,000

1 Except where otherwise indicated, the amount applicable to quarters is one-half the amount for semi-annual periods.

(15160)

Trans World Airlines, Inc.

Period	Amount
Semi-Annually:	
February 5-June 30, 1946	$ 5,035,397
Second half 1946	6,346,603
First half 1947	6,517,765
Second half 1947	6,517,766
First half 1948	1,078,868*
Second half 1948	1,257,624*
First half 1949	1,263,749*
Second half 1949	1,286,563*
First half 1950	1,277,492*
Second half 1950	1,561,479*
First half 1951	1,698,214*
Second half 1951	1,872,442*
First half 1952	1,804,219*
Second half 1952	1,803,145*
First half 1953	1,962,000*
Third quarter 1953	887,000*
Monthly:	
October 1953	331,145*
November 1953	343,790*
December 1953	688,739*
Total	$43,534,000

* Equivalent to service rate of 85 cents times the monthly U. S. Mail ton-miles.

Pan American World Airways, Inc.

Period	Amount
Semi-Annually:	
First half 1946	$ 2,250,500
Second half 1946	2,250,500
First half 1947	2,947,500
Second half 1947	2,947,500
First half 1948	6,517,000
Second half 1948	6,517,000
First half 1949	6,337,500
Second half 1949	6,337,500
First half 1950	7,374,500
Second half 1950	7,374,500
First half 1951	5,040,500
Second half 1951	5,040,500
First half 1952	5,879,500
Second half 1952	5,879,500
First half 1953	3,545,000
Third Quarter 1953	1,772,500
Monthly:	
October 1953	590,833
November 1953	511,687
December 1953	669,980*
Total	$79,784,000

* Equivalent to a service rate of 85 cents times the monthly U. S. mail ton miles.

(15162)

B501

15162

Order No. E-10117

UNITED STATES OF AMERICA

CIVIL AERONAUTICS BOARD

WASHINGTON, D. C.

Adopted by the Civil Aeronautics Board
at its office in Washington, D. C.,
on the 23rd day of March, 1956.

In the Matter of the TRANSATLANTIC FINAL MAIL RATE CASE	Docket No. 1706, *et al.*

ORDER FIXING MAIL RATES

The Board, having issued an Opinion and a Supplemental Opinion in the above-entitled proceeding (Orders No. E-8833, December 20, 1954 and E-9530, August 30, 1955) and having considered the record and all the documents submitted in the proceeding reopened by Order No. E-8872, September 29, 1954, and made its findings and conclusions on such reopened record and having considered the entire record and all the documents filed in this proceeding and made its findings and conclusions on the entire record, all of which findings and conclusions are contained in the attached Opinion which is made a part hereof:

IT IS THEREFORE ORDERED, THAT

The fair and reasonable rates of compensation to be paid each of the carriers named below for the transporta-

tion of mail by aircraft, the facilities used and useful therefor and the services connected therewith on the routes described below and for the periods listed below are as follows:

A. To American Overseas Airlines, Inc., for the period January 1, 1946, through September 25, 1950, over its entire system, the sum of $22,613,000.

B. To Pan American World Airways, Inc., for operations between the points between which the carrier has been authorized to carry mail by its certificates of public convenience and necessity authorizing transatlantic operations to points in Bermuda, Europe, Africa and Asia.

1. For the period January 1, 1946 through December 31, 1953, the sum of $79,784,000.

2. For each calendar month during the calendar year 1954, in which miles designated by the Postmaster General for the transportation of mail are flown, a rate of 50.90 cents to be applied to the scheduled miles flown during the month, or 44,024 miles times the number of days in the month, whichever is the lower: *Provided, however,* That

a. For the calendar year 1954, the amount of mail pay computed in accordance with paragraph 2 shall be reduced by the amount of $54,000; and

b. The total amount of mail compensation payable pursuant to this order for the 12 month period ended on December 31, 1954, shall be as set forth in (1) or (2) below, whichever is the higher:

(1) The amount computed in accordance with the formula above for each month in such period; or

(15163)

(2) The amount computed in accordance with the applicable service mail rate or rates for each month in such period.

The scheduled miles flown shall be computed on the direct airport-to-airport mileage between the points actually served on each revenue trip operated over Pan American's authorized transatlantic routes pursuant to its flight schedules filed with the Board, including all revenue trips operated as extra sections thereto.

C. To Trans World Airlines, Inc., for operations between the points between which it has been authorized to carry mail by its certificates of public convenience and necessity other than certificates authorizing (a) interstate air transportation as defined in the Civil Aeronautics Act, and (b) air transportation between the United States and terminal points in Canada for the period February 5, 1946, through December 31, 1953, the sum of $43,534,000.

The compensation provided herein shall be in lieu of, and not in addition to, the mail compensation heretofore received by American Overseas Airlines, Inc., Pan American World Airways, Inc., and Trans World Airlines, Inc., for the respective services and periods covered herein: *Provided, however,* That

(a) The compensation established herein for Pan American World Airways, Inc., American Overseas Airlines, Inc., and Trans World Airlines, Inc., for periods prior to January 1, 1954, shall be adjusted in the event of any amendment of Section 11 of the Internal Revenue Code resulting in an effective corporate income tax rate for the calendar year 1956 which is greater or less than 48.25 percent. Upon the effective date of any such amendment, the amount of mail pay determined for American Overseas Airlines, Inc.,

herein and the amounts of mail pay determined for Trans World Airlines, Inc., and Pan American World Airways, Inc., shall be computed on the basis of the income tax rate so established.

(b) The compensation determined herein for American Overseas Airlines, Inc., and Pan American World Airways, Inc., is subject to such adjustments as may be required in the event that the actual Federal Income Tax liability

15164

of either or both such carriers with respect to the additional mail pay awarded herein to American Overseas Airlines, Inc., is greater or less than $2,387,000.

(c) The compensation determined herein for Pan American World Airways, Inc., for the period beginning January 1, 1954, is subject to such reduction for the period January 1, 1954, through December 31, 1954, as may be required by the Board's final determination in the *Trans-Pacific Mail Rate Case,* Docket No. 6429, or other proceeding in which the need of the carrier as a whole for the period January 1, 1954, through December 31, 1954, may be determined.

IT IS FURTHER ORDERED, That insofar as the exceptions, brief, and argument of Trans World Airlines, Inc., request further reconsideration of issues previously decided by the Board by Orders No. E-8672, E-8833, E-9282 and E-9530, the request is dismissed.

IT IS FURTHER ORDERED, That insofar as the exceptions, brief, and argument of Trans World Airlines, Inc., request further reconsideration of the Board's previous rulings in Orders No. E-9441 and E-9598, the requested reconsideration is denied.

(15164)

IT IS FURTHER ORDERED, That this order shall be effective immediately.

By the Civil Aeronautics Board.

/s/ M. C. MULLIGAN

M. C. Mulligan
Secretary

(SEAL)

15165

Order No. E–10176

UNITED STATES OF AMERICA

CIVIL AERONAUTICS BOARD

WASHINGTON, D. C.

Adopted by the Civil Aeronautics Board
at its office in Washington, D. C.,
on the 9th day of April, 1956

In the matter of the REOPENED TRANSATLANTIC FINAL MAIL RATE CASE	Docket No. 1706, *et al.*

SUPPLEMENTAL ORDER FIXING MAIL RATES[1]

Under the provisions of Order No. E-10117, adopted March 23, 1956, the mail rates fixed therein for American Overseas Airlines, Inc. (AOA), Pan American World Airways, Inc. (PAA), and Trans World Airlines, Inc. (TWA), for periods prior to January 1, 1954, were subject to adjustment in the event that the corporate income tax rate applicable for calendar 1956 was changed by amendment to the Internal Revenue Code. On March 29, 1956, Public Law 458, 84th Congress, 2nd Sess., 1956, extending the 30 percent normal tax rate applicable to corporations until March 31, 1957, became law, increasing

1 The adoption of this order will not extend the time allowed for petitions for reconsideration of the Board's decision of March 23, 1956, Order No. E-10117, which must be filed not later than April 23, 1956.

the effective 1956 tax rate applicable to the three carriers from 48.25 percent to 52 percent.

On the basis of the tax rates fixed by Public Law 458, *supra*, and the provisions of Order No. E-10117, *supra*, the Board finds that the fair and reasonable mail rates for the three carriers involved, for the periods indicated, are as set forth below.[2]

IT IS THEREFORE ORDERED, THAT

The fair and reasonable rates of compensation to be paid each of the carriers named below for the transportation of mail by aircraft, the facilities used and useful therefor and the services connected therewith on the routes described below and for the periods listed below are as follows:

A. To American Overseas Airlines, Inc., for the period January 1, 1946, through September 25, 1950, over its entire system, the sum of $22,399,000.

15166

B. To Pan American World Airways, Inc., for operations between the points between which the carrier has been authorized to carry mail by its certificates of public convenience and necessity authorizing transatlantic operations to points in Bermuda, Europe, Africa and Asia.

1. For the period January 1, 1946 through December 31, 1953, the sum of $79,431,000.

2. For each calendar month during the calendar year 1954, in which miles designated by the Postmaster General for the transportation of mail are flown, a rate of

2 The computation underlying these rates is set forth in the appendices attached; the administrative allocation of total mail pay appears in Appendix No. 6, attached.

50.90 cents to be applied to the scheduled miles flown during the month, or 44,024 miles times the number of days in the month, whichever is the lower: *Provided, however,* That

a. For the calendar year 1954, the amount of mail pay computed in accordance with paragraph 2 shall be reduced by the amount of $54,000; and

b. The total amount of mail compensation payable pursuant to this order for the 12 month period ended on December 31, 1954, shall be as set forth in (1) or (2) below, whichever is the higher:

(1) The amount computed in accordance with the formula above for each month in such period; or

(2) The amount computed in accordance with the applicable service mail rate or rates for each month in such period.

The scheduled miles flown shall be computed on the direct airport-to-airport mileage between the points actually served on each revenue trip operated over Pan American's authorized transatlantic routes pursuant to its flight schedules filed with the Board, including all revenue trips operated as extra sections thereto.

C. To Trans World Airlines, Inc., for operations between the points between which it has been authorized to carry mail by its certificates of public convenience and necessity other than certificates authorizing (a) interstate air transportation as defined in the Civil Aeronautics Act, and (b) air transportation between the United States and terminal points in Canada for the period February 5, 1946 through December 31, 1953, the sum of $42,942,000.

The compensation provided herein shall be in lieu of, and not in addition to, the mail compensation heretofore

received by American Overseas Airlines, Inc., Pan American World Airways, Inc., and Trans World Airlines, Inc., for the respective services and periods covered herein: *Provided, however,* That

15167

(a) The compensation determined herein for American Overseas Airlines, Inc., and Pan American World Airways, Inc., is subject to such adjustments as may be required in the event that the actual Federal Income Tax liability of either or both such carriers with respect to the additional mail pay awarded herein to American Overseas Airlines, Inc., is greater or less than $2,773,000.

(b) The compensation determined herein for Pan American World Airways, Inc., for the period beginning January 1, 1954, is subject to such reduction for the period January 1, 1954, through December 31, 1954, as may be required by the Board's final determination in the *Trans-Pacific Mail Rate Case,* Docket No. 6429, or other proceeding in which the need of the carrier as a whole for the period January 1, 1954, through December 31, 1954, may be determined.

IT IS FURTHER ORDERED, That this order shall be effective immediately.

By the Civil Aeronautics Board:

/s/ M. C. MULLIGAN

M. C. Mulligan
Secretary

(SEAL)

APPENDIX A (14633)

14633

UNITED STATES OF AMERICA

CIVIL AERONAUTICS BOARD

WASHINGTON, D. C.

REOPENED TRANSATLANTIC FINAL MAIL RATE CASE

Docket No. 1706 *et al.*

Found that the operating divisions of Pan American, other than the Transatlantic, have $13,490,000 excess earnings with which to reduce the subsidy requirements of Pan American for transatlantic service.

Found that the operating divisions of TWA, other than the Transatlantic, have $8,715,000 excess earnings with which to reduce the subsidy requirements of TWA for transatlantic service.

Appearances:

ELIHU SCHOTT for Pan American World Airways, Inc.

GEORGE A. SPATER for Trans World Airlines, Inc.

ABE MCGREGOR GOFF, FREDERICK E. BATRUS, and EUGENE J. BRAHM for the Post Office Department.

MILTON H. SHAPIRO and ARTHUR H. SIMMS, Bureau of Air Operations.

INITIAL DECISION OF EXAMINER RALPH L. WISER

This initial decision covers matters sometimes referred to as "offset" issues involved in the *Transatlantic Final*

(14633, 14634)

Mail Rate Case, raised as a result of the decision of the United States Supreme Court in *C.A.B.* v. *Summerfield*, 347 U. S. 74 (1954). In the latter proceeding, which involved a mail rate of Chicago and Southern Air Lines, Inc., the Supreme Court held that in fixing a subsidy rate under section 406(b)

14634

of the Act, the Board is required to follow the special formula established by Congress in that section. The Court found that, while the rate could be for a class of service, the return in form of a subsidy must be computed with reference to the entire operations of the carrier. Accordingly, in determining the subsidy need for one division of an air carrier the Board must offset against that need any excess earnings of other divisions. Hearing on other issues had been held in the *Transatlantic Final Mail Rate Case*, but evidence to enable such offset had not been included. Accordingly, by Order No. E-8672 of September 29, 1954, the Board reopened that case to determine the extent of excess earnings of Pan American and TWA available for offset against the subsidy of their transatlantic divisions in accordance with its opinion accompanying the order. In Order No. E-9282 of June 7, 1955, the Board, acting on petitions for reconsideration, generally reaffirmed the conclusions set forth in the opinion of September 29, 1954.

More particularly, this reopened phase of the *Transatlantic Final Mail Rate Case* involves a determination of the extent to which the operating divisions of Trans World Airlines, Inc. (TWA) and Pan American World Airways, Inc. (Pan American) other than the transatlantic had earnings under the terms of Section 406(b) of the Civil Aeronautics Act, as amended, available to reduce the subsidy requirements of the

carriers' transatlantic service during the following periods:[1]

(1) For TWA

(a) The period February 5, 1946, through March 13, 1947; and

(b) The period January 1, 1951, through December 31, 1953;[2]

(2) For Pan American

(a) The period January 1, 1951, through December 31, 1953, for the Pacific divisions;[3]

(b) The period July 1, 1951, through December 31, 1953, for the Alaska division; and

---

1 The rate periods involved for the transatlantic operations date from January 1, 1946, in the case of Pan American and February 5, 1946, in the case of TWA and in both cases continue into the future period. For purposes of determining excess earnings available for offset, however, the Board has ruled that there should be excluded from consideration operations of divisions other than transatlantic for which past-period rates were set by the Board; e.g., the period March 14, 1947,—December 31, 1950, for TWA, which was the past period for TWA in the *Big Four Mail Rate Case* (*American Airlines, Inc., et al., Mail Rates*, 14 C.A.B. 558 (1951); Order No. E-8672, September 29, 1954, Opinion, pp. 11 *et seq.*)

2 By the Board's Order No. E-9441, dated July 28, 1955, a motion of TWA filed June 2, 1955, was granted to the extent that the carrier requested that its right to subsidy in the transatlantic division in the period subsequent to January 1, 1954, be waived and that evidence concerning its domestic-division earnings in the period subsequent to January 1, 1954, be excluded from consideration in the reopened phase of this proceeding.

3 By letter of May 13, 1955, Pan American requested that the issues in the reopened proceeding, insofar as they affect Pan American, be limited to the period December 31, 1953, with the understanding that the issue of excess earnings available for offset against the Atlantic division subsidy for the period beginning January 1, 1954, will be considered in the pending *Transpacific Mail Rate Case*, Docket No. 6429, or in other proceedings, and with the further understanding that in such other proceedings there will also be considered the issue of the deficiency of earnings of the Atlantic division for the period beginning January 1, 1954. This letter included a statement that Bureau Counsel had authorized the writer to state Bureau Counsel's concurrence in the request, and Examiner Merritt Ruhlen, who was in charge of the proceeding at that time, ruled in a notice dated May 24, 1955, that the issues would be so limited.

(c) The calendar year 1953 for the Latin American division (LAD).

14636

Offset Against Pan American's Subsidy

Bureau Counsel contends that Pan American's Pacific, Alaska, and Latin American Divisions had net earnings totalling $13,806,000 before taxes for the periods involved herein which are available to reduce the subsidy requirements of its Transatlantic Division. Appendix No. A shows the detailed computations. Pan American contests these showings, contending that (1) Bureau Counsel errs by using an approach that all earnings of the other Pan American Divisions in excess of a 10-percent return on investment are excess and to be offset, (2) the details of Bureau Counsel's statement of excess profits are wrong in that (a) the amount of capitalized interest allowed should be based on the source from which equipment-purchase funds were derived rather than the Bureau Counsel method of using actual rates of interest on long-term borrowings to the extent that there is such debt outstanding (up to the amount of the equipment-purchase funds), (b) the Bureau errs in proposing to determine Pan American's excess earnings by including a disallowance of $133,000 computed by reducing Pan American's allowable Latin-American Division DC-3 maintenance expense for 1953 to a level of $25 per hour flown and, (c) the Bureau erroneously includes in its computation of excess earnings and adjustment that excludes all 1953 Latin-American Division expenditures for selling expense in excess of 19 percent o. adjusted commercial revenues.

14637

Capitalized Interest on Equipment-Purchase Funds. There is dispute concerning interest on deposits made by both Pan American and TWA with manufacturers in connection with aircraft-purchase contracts. The Board has over a considerable period followed the practice of recognizing capitalized interest on equipment-purchase funds as a legitimate part of the rate base after the property units are in actual operation. The dispute here concerns the capitalization rate to be used in computing the interest on deposits. Pan American and TWA claim that the amount of capitalized interest should reflect the source from which the equipment-purchase funds were derived. The Bureau of Air Operations quotes decisions of the Board holding that "to the extent that the carrier has borrowed capital outstanding during all or part of the period involved, the interest rate actually paid on its borrowed funds should be the rate to be capitalized,"[4] and contends that this policy should be followed here. It points out that this principle, originally stated in 1947 in the *Pan American—Transatlantic Mail Rate Case,* was reiterated in the *Pan American, Transpacific Mail Rate Case.*[5] In the latter case, the equipment deposits exceeded the carrier's long-term debt, and a portion of the deposit was treated as derived from debt and the rest, as derived from equity. The carrier argued that as each aircraft was delivered the related deposit should be reduced by applying a pro rata amount of both equity funds and bank loans. Bureau Counsel took the view that deposits from equity funds should be reduced first. The Board found as follows:

---

4 *Pan American, Transatlantic Mail Rate Case,* 8 C.A.B. 267, 286 (1947).

5 14 C.A.B. 818 (1951).

> "We have no difficulty with the argument concerning the separation of equity and bank loan deposits on B-377 aircraft. Pan American's interest computations applied the deposits made from equity funds against the last aircraft received. Application of the deposits made from equity funds against the first aircraft received is in accord with the decision in the Transatlantic Mail Rate Case, *supra,* that the interest rate to be capitalized is the interest rate actually paid on borrowed funds to the extent that the carrier has such capital outstanding. Therefore, the carrier's proposal to prorate equity and bank-loan funds to each aircraft will not be accepted."

It is true that the policy proposed by Bureau Counsel has been followed by the Board in the above and other previous cases. However, no published opinion has been brought to the Examiner's attention in which the Board has decided that it would consider an equipment-purchase-fund deposit to be financed by borrowed funds although the carrier could show that equity funds had been utilized. For example, in the *Transpacific Mail Rate Case,* the Board pointed out that Pan American contended that there was no practical way to determine whether the deposits applied against any particular payments were derived from equity funds or from the proceeds of bank loans.[6] The opinions do not appear to contain any discussion of the problem now presented. Accordingly, the above policy decisions having been made under circumstances in which the source of funds was not apparent, the question now presented is one of first impression.

---

6 14 C.A.B. 818, 826 (1951).

Review of the Board's opinions reveals two primary reasons for its policy of distinguishing between equity and borrowed capital and for its method of deciding which interest rate to apply. First, the Board indi-

14639

cated in the *Transatlantic Mail Rate Case*[7] that it would allow a higher rate for use of equity than for borrowed capital because of the higher cost of equity funds and because it desired to provide an incentive to air carriers for use of equity financing and the avoidance of speculative capital structures by contracting heavy burdens of debt. Second, reference in the *Transpacific Case* to Pan American's contention that the sources of particular payments could not be determined appears to indicate that the difficulty of determining the actual source of capital used in a specific program was a factor deemed significant by the Board in its determination in that proceeding to consider as borrowed funds the amount of the deposits to the extent there were borrowed-fund liabilities outstanding. Neither of these reasons requires application here of the policy of considering all deposits as borrowed funds to the extent of any borrowed funds outstanding.

It appears that the position taken by the carriers has merit. When it can be established that borrowed funds have been fully applied, either to a different equipment-purchase program or to uses other than the purchase of equipment (such as the instance cited by Pan American in which money was borrowed to purchase American Overseas Airlines in 1950), it would seem obvious that equity money must have been used. Where the facts clearly show that equity funds have been used for a particular deposit, it is apparent that recognition of that fact would

7 8 C.A.B. 267 (1947).

be made in determining mail rates unless some contrary reason required use of the fiction that borrowed funds

14640

had been utilized. No such contrary reason has been brought to the Examiner's attention. It is recommended that the Board further clarify its policy with respect to capitalized interest so as to provide for consideration as equity financed any equipment-purchase-fund deposits which the evidence shows to have been financed by equity capital. In the light of the above considerations, it is found that the offset computations herein should be made in accordance with the foregoing recommendation and the appropriate interest rate based on the source of funds will be applied. Appendix C reflects such an adjustment of Bureau Counsel's figures for Pan American.

DC-3 Maintenance Expense. Bureau Counsel's analysis includes a disallowance of Pan American's DC-3 maintenance expense during 1953 in the Latin American Division in excess of $25 per hour, representing a total disallowance of $133,000. Bureau Counsel bases its position upon a comparison with the DC-3 maintenance cost of other carriers operating this equipment in Latin America and over domestic trunkline routes. It shows that expenses of Panagra and Delta-C&S, two carriers operating in the Latin American area, averaged $24.96 in 1952 and $25.60 in 1953, and that those of 11 domestic carriers averaged $27.87 in 1952 and $27.19 in 1953. Bureau Counsel points out that the Board recognized only $25 per hour for Pan American's Latin American Division in fixing the rate for the future period beginning January 1, 1953,[8] and that the

[8] *Pan American World Airways, Inc. Latin American Division, Mail Rates*, Docket No. 3308, Order No. E-7650 (p. 10), finalized by Order No. E-7673, September 1, 1953.

same figure has been fixed by the Board as the maximum allowance for domestic trunkline carriers.[9]

14641

Pan American objects to any adjustment for this item, alleging that practically all of its DC-3 maintenance was performed at its Brownsville, Texas, base; that, in order to render operation of the base economic, it solicited and performed work for other companies and for the Government; that the outside work resulted in profits of $361,000 in 1953, which were included in the incidental revenues of the Latin American Division as computed by Bureau Counsel; and that, since this profit is substantially greater than the amount of DC-3 expense in excess of $25 per hour, it would be improper to disallow any expense in connection with this facility.

While Bureau Counsel showed certain minor faults in the carrier's computation of $361,000 profit, no adjustments of expenses have been suggested that would bring the profit down to a figure below the alleged excess expense.[10] The revenue from the outside work was included in Pan American's reports and is included by Bureau Counsel in computing the amount available for offset. Under the circumstances, it does not appear that the Brownsville

---

9 *Colonial Airlines, Inc., Mail Rates*, Docket No. 5497, Order No. E-6926, October 29, 1952, (Provisional Statement, pp. 8-9), finalized by Order No. E-6999, December 2, 1952; *Northeast Airlines, Inc., Mail Rates*, Dockets Nos. 1932 and 1890, Order No. E-7368, May 11, 1953, (Provisional Statement, pp. 10-13), finalized by Order No. E-7443, June 5, 1953; *Braniff Airways, Inc., Domestic Operations, Mail Rates*, Docket No. E-6483, Order No. E-8402 (Provisional Statement, pp. 14-15), finalized by Order No. E-8440, June 15, 1954.

10 Bureau Counsel submits on brief an argument that consideration of a 10-percent return on an allocation of working capital to the work for other companies and the Government would reduce this profit to a point below the excess expenses. However, Pan American's working capital total was well below allowable limits, and no suggestion had previously been made that any of it should be excluded.

operation resulted in excess cost to the Government, and Bureau Counsel's proposed $133,000 disallowance cannot be accepted. Appendix C reflects the adjustment of Bureau Counsel's figures so as to allow this expense.

14642

Selling Expense. Pan American's Latin American Division reported selling expense in 1953 which constituted 20.18% of commercial transportation revenues from passenger, express and freight, excess baggage, and other transportation revenues (revenues and the related selling expenses assignable to all-cargo services, foreign-mail revenues, and non-scheduled revenues are excluded). The Bureau of Air Operations takes the position that selling expense in excess of 19 percent of these commercial revenues should be disallowed. It bases its position on three primary contentions. First, it stresses heavily the fact that the Board gave careful consideration to the matter of the proper selling-expense level of this Division of Pan American in determining the past-period rates and also the mail rate for the future period beginning January 1, 1953. The Board adopted 19 percent as the benchmark from which to test the reasonableness of selling expenses for the Latin American Division and for the larger American Flag carriers in general and announced that any upward departure therefrom would have to be specifically justified.

The Bureau relies upon the following portions of the Board's opinion in respect to the past-period rate:

> "On the basis of CAB Form 41 reports on file with the Board, the level of LAD's selling expenses . . . appeared to be unreasonably high in comparison with the expense level reported by other international carriers. Appendix No. 10 shows that the

level of traffic and sales and advertising and publicity expenses of LAD was higher during 1948, 1949, and 1950 than the level of several other carriers, and higher in all four years of the review period than the arithmetic average of the American Flag Carriers, excluding LAD, but including all the divisions of Pan American.

"The high level of selling expenses reported by LAD is accentuated by the fact that in terms of traffic LAD has been and is in

14643

a better position than any of the other international carriers. LAD's revenue ton-miles per route mile per day ranged from 17.37 tons to 22.44 tons in the review period and were approximately three times those of Panagra, and over twice the average of the American Flag Carriers excluding LAD. In view of these facts, and the further fact that traffic and sales expenses of LAD reflect substantial payments to affiliated companies, the selling expenses of the carrier were subjected to careful study."[11]

• • • •

"In reaching our conclusions as to the proper level of selling costs for this particular carrier, we have borne in mind the fact that this is an area which is most susceptible to the control of management and which subsidy carriers must keep within reasonable bounds. For this reason, the standard of 19 percent of appropriate non-mail revenues is adopted as the benchmark from which to test the reasonable-

11 *Pan American World Airways, Inc., Latin American Division, Mail Rates*, Docket No. 3308, Order No. E-7441, June 5, 1953, (Provisional Statement, pp. 29-30), finalized by Order No. E-7495, June 19, 1953.

> ness of selling expenses for LAD and for the larger American Flag Carriers in general. Any upward departure from the 19 percent level will have to be specifically justified."[12]

It relies upon the following part of the Board's opinion passing upon Pan American's claim of a 20-percent selling-expense level for purposes of the future rate period beginning January 1, 1953:

> "This level is substantially above the 19 percent of appropriate nonmail revenues recognized by the Board for this carrier for the year 1951. In its statement dealing with the period ending December 31, 1951, the Board indicated that any upward departure from the 19-percent level would have to be specifically justified. The carrier has not shown that in 1953 there are changed circumstances which call for such departure. Accordingly, on the basis of the data and the reasons as set forth in that statement—which are incorporated herein by reference—the reasonableness of the 19 percent of selling expenses is reaffirmed." (Footnotes omitted.)[13]

Second, the Bureau contends that the reasonable maximum selling-expense ratio for this Division is 19 percent. It points out that the

20.18-percent experience of Pan American here in 1953 was somewhat below the 20.54-percent of the other U. S. Latin American carriers for that year and somewhat above

12 Id. at p. 32.

13 *Pan American World Airways, Inc., Latin American Division, Mail Rates*, Docket No. 3308, Order No. E-7650, August 19, 1953, (Provisional Statement, p. 12), finalized by Order No. E-7673, September 1, 1953.

the 19.67-percent average of the other American Flag carriers. However, it believes that this Division of Pan American has advantages which make the proper selling-expense ratio substantially less than those of other international carriers.

Viewing the operating characteristics of the Latin American Division as a whole, the Bureau shows that this Division enjoyed a favorable position in comparison with others in 1953 with respect to (1) route density (revenue ton-miles per route-mile of 3½ times the other U. S. Flag Latin American carriers and twice that of all American Flag carriers, revenue ton-miles per station of three times the other Latin American carriers), (2) volume of operations (5 times the available seat-miles of Panagra and 10 times those of Braniff and Delta), (3) load factor (highest of the Latin American carriers), and (4) competitive position (it holds a dominant competitive position in Latin American with the largest route system, equal or superior equipment, and a worldwide reputation).

The Bureau also looks at the New York-San Juan local service, which accounted for 30 percent of the Latin American Division's revenue ton-miles. This service has characteristics comparing favorably with domestic trunkline operations, and the Bureau concludes that its selling-expense ratio should be closer to the 12-percent average of the Big Four than to the 19 percent proposed for the Latin American Division as a whole. It shows

that, if a 15-percent level were allowed for the New York-San Juan portion, the remainder of the Latin American Division would have a 20.5-percent allowance under a 19-percent allowance for the entire Division. The Bureau then shows that after excluding the strong San Juan-New York service the Latin American Division occupies a

favorable comparative position. Compared with the average of all other U. S. Flag Latin American carriers, it had 6 times the total revenue ton-miles, 2 times the daily revenue ton-miles per route-mile, 2 times the revenue ton-miles per station, a slightly smaller pasenger yield, ½ the average passenger haul in miles, 3 times the number of passengers per station per day, and a 25% greater load factor. Compared with the average of all other U. S. Flag international carriers, it had twice the total revenue ton-miles, 25% more revenue ton-miles per route-mile, ¾ the revenue ton-miles per station, a slightly higher passenger yield, a little less than half the average passenger haul, twice the passengers per station per day, and a 6% higher load factor. The Bureau believes that the above facts show that the overall 19-percent allowance is consistent with the 19.5-percent level established for the transatlantic operations in this proceeding[14] and with the 20-percent ratio established by the Board for the smaller Latin American carriers.[15]

Fourth, the Bureau argues against Pan American's contention that the 1953 selling expenses should be allowed because a carrier ought to be free

to apply higher selling expenses and obtain greater revenue. It points out that the carrier has made no showing that any part of its excess earnings resulted from its excess selling expenses.

Pan American strongly opposes the Bureau's proposed disallowance of selling expenses. First, it contends that

14 Order No. E-8833, December 20, 1954, Opinion, pp. 36-41.

15 *Braniff Airways, Inc., Latin American Operations, Mail Rates*, Docket No. 2886, Order No. E-8354, May 19, 1954. (Provisional Statement, p. 10), finalized by Order No. E-8439, June 15, 1954; *Chicago and Southern Air Lines, Inc., Latin American Operations, Mail Rates*, Docket No. 2564, Order No. E-5385, May 18, 1951, (Tentative Statement, p. 27), finalized by Order No. E-5793, October 18, 1951.

selling expenses made by a carrier operating under a closed rate should not be subject to hindsight review and that any presumption that might attach to the Board's use of a particular level in a forecast is far outweighed by the fact that the carrier, spending what it had every reason to believe was its own money for its own account, saw fit to spend more and did better than was forecast. Second, Pan American alleges that the experience of other carriers and the Board's allowance of a 19.5 ratio in the transatlantic operations fully support the reasonableness of the Latin American Division expense level. The carrier points out that Bureau Counsel identified no particular practice or expenditure as being inefficient and that he relied, instead, on prior Board decisions and comparisons with other carriers. But it believes its comparison to be favorable. It points out that the 19.5-percent selling-expense ratio of the Latin American Division (before adjustment to exclude all-cargo service) compares with 20.5 percent for the 3 other U. S. Latin American carriers and 21.5 percent for the 2 Atlantic carriers. It submits the following comparisons of system strengths in support of its contention that the transatlantic operation has the opportunity to achieve lower selling-expense ratios than the Latin American Division:

	LAD	PAA Atlantic	TWA International
1. Size of carrier in revenue ton-miles (000)	106,377	93,889	68,494
2. Volume of revenue (000)	$58,103	$59,419	$45,145
3. Trend of revenue			
Increase 1952 to 1953	2.9%	7.1%	10.3%
Increase 1951 to 1953	6.5%	28.0%	27.5%
Increase 1950 to 1953	16.7%	81.2%	46.7%
4. Traffic density			
Revenue ton-miles per route-miles per day	21.4	11.9	15.1
Revenue ton-miles per station (000)	2,401	2,085	2,834
Passengers per station per day	45.6	38.1	21.9
5. Relative yield			
per passenger-mile	6.13¢	7.77¢	7.94¢
per cargo ton-mile	31.9 ¢	43.1 ¢	45.4 ¢
6. Passenger load factor	65.4%	60.3%	68.0%
7. Average passenger haul (miles)	979	1,065	2,550
8. Competition	Not subject to statistical measurement, but severe for all.		
9. Revenue per passenger	$60.03	$82.82	$202.53

Appraising the foregoing presentations, the Examiner concludes that the Bureau has proved its point. The Board, after careful review, fixed a ratio of 19 percent as the benchmark from which to test the reasonableness of Latin American Division selling expenses and adopted a policy that any upward departure would have to be specifically justified. The comparisons

14648

submitted do not appear to justify the increase here involved. Generally speaking, the Latin American Division route system compares favorably in strength with the transatlantic operation. In addition, Pan American has a much more dominant position in its Latin American Division than it does in the Atlantic with respect both to its U. S. and its foreign competitors. It should, therefore, require a lower selling-expense ratio here. Accordingly, the proposal of Bureau Counsel for an adjustment of selling expenses to 19-percent of commercial revenue is found reasonable.

14649

OFFSET AGAINST TWA'S SUBSIDY

Bureau Counsel submitted an analysis in support of the position of the Bureau of Air Operations that $8,942,000 of TWA's Domestic-Division earnings before taxes are available for offset against its subsidy for the Atlantic Division during the periods here involved. Appendix No. B shows the details of the computation. TWA asserts first, that the Bureau is wrong in that TWA's Domestic Division had no excess profits under the criteria previously established by the Board, that its Domestic Division must be allowed to retain earnings up to the level of its competitors, that the rate of return for an airline

cannot possibly be based on a fixed percentage, and that the cost-of-capital approach cannot be used to determine the proper level of earnings for offset purposes. Second, TWA argues that the Bureau wrongly computed the earnings for offset purposes with respect to (1) disallowing strike losses, (2) its treatment of capitalized interest on equipment-purchase funds, (3) allocation of refund of 1944-1945 taxes, (4) treatment of book profits from sales of equipment and parts, and (5) offsetting any of the 1953 domestic earnings against subsidy.

Strike Losses. TWA's domestic and international operations were suspended as a result of a strike of the carrier's pilots in 1946. The loss to its International Division in the amount of $666,000 was disallowed by the Board in its opinion of December 20, 1954.[16] This

conclusion with respect to the international operations was reaffirmed in the Board's Supplemental Opinion on Reconsideration issued August 30, 1955, Order No. E-9530 (Opinion, p. 3). Bureau Counsel now proposes, in reviewing the carrier's operating results for the Domestic Division for the determination of the amount available for offset, to disallow Domestic-Division losses amounting to $1,130,000 ascribable to the pilots' strike. TWA strongly opposes Bureau Counsel. It refers to the Board's opinion of December 20, 1954, with respect to the strike losses in the International Division in which the Board stated:

> "There is nothing in the language of our statute which requires that we provide a carrier with subsidy for losses due to a failure to provide the service for which it was certificated."

16 *Transatlantic Final Mail Rate*, Order No. E-8833, dated December 20, 1954, Opinion, p. 35.

TWA believes that there is no possibility of such underwriting with subsidy here inasmuch as its Domestic Division was paid only a service rate, and the question is not whether that Division should be subsidized for strike losses but, rather, how much of the service payments it will be allowed to keep. It argues that Bureau Counsel's claim amounts, in effect, to a proposal that TWA not only bear the full cost of the strike but as a penalty pay an equivalent amount to the Government as an offset.

Looking at the Board's decision which would require the cost of the strike to be met out of the return on investment, TWA contends that the Board cannot say that the cost of a strike must come out of

14651

the rate of return and, at the same time, say that it is to be disregarded in computing TWA's rate of return during the review period. It refers to the Board's finding on page 94 of the opinion of December 20, 1954, that the cost of capital for the Big Four Carriers ranges between 7.449 percent and 8.118 percent, alleges that the 8-percent rate of return advocated for TWA by Bureau Counsel purports to be repayment of the cost of capital, argues that the cost of capital is computed on earnings-price ratios after the cost of strikes has been accounted for in earnings, and concludes that awarding an 8-percent rate of return to TWA and at the same time disallowing its strike costs would give the company less than its allowabe cost of capital.

Bureau Counsel argues that the Board's prior determination on this issue with respect to the International Division losses requires that the Board disallow the strike losses in the Domestic Division. It points out that the preliminary offset decision herein of September 29, 1954, requires that the determination of excess earnings of other

divisions be made on the basis of the statutory standards of Section 406, that the December 20, 1954, opinion holds that strike losses are not allowable under Section 406; and argues that the result of these two decisions is to compel disallowance of the domestic strike losses in computing the amount for offset.

The Board's decision in *Braniff Airways Mail Rate Case*, 9 C.A.B. 607, 616 (1948); its decision in the *Transatlantic Final Mail Rate Case*,

14652

Order No. E-8833; and its supplemental opinion on reconsideration therein, Order No. E-9530, dated August 30, 1955, clearly indicate that the Board has determined that strike losses represent a type of cost neither normal nor recurrent in nature, that no accurate prediction can be made as to their incidence with respect to a particular carrier, and that the risk of such cost exists in the case of all carriers and represents one of the risks of doing business which is reflected as a normal cost of capital rather than as a normal cost of operation. The Board first treated this kind of cost in the above-referenced *Braniff Airways Mail Rate Case*, in which the cost attributable to the grounding of aircraft types was under consideration. It is true that in a subsequent decision the Board found that aircraft grounding costs should be capitalized (*American Airlines, et al., Mail Rate Case*, 10 C.A.B., 341 (1949)) but, as pointed out in the Board's opinion of December 20, 1954, in the *Transatlantic Final Mail Rate Case*, this action with respect to aircraft grounding cost was expressly recognized as an exception to the general policy which was warranted by the public-interest needs for encouraging carriers in developing new aircraft types. In its decision in the *Transatlantic Final Mail Rate Case* of December 20, 1954, the Board specifically found that strike losses do come within the type of cost covered in

the Braniff case, and that there was no reason shown for departing from the general policy of requiring abnormal risks which are neither measurable nor predictable to be met out

of the return on investment. Discussing the adequacy of rate of return to cover strike losses, the Board in that opinion pointed out that there is a great difference between the risk of a strike and the loss occasioned thereby, and that there has been no demonstration in the record that, viewed on an industry-wide basis, the strike risk is anything but a relatively small one. It found that there had been no showing that this risk represents more than a negligible part of the 7-percent rate of return on investment for past-period operations or that the 7-percent return is inadequate to cover such risks. Similar findings with respect to the strike risk and its relation to the 8-percent return are justified.

In the light of the foregoing considerations, it is found that the Domestic-Division losses ascribable to the pilots' strike should be disallowed.

Capitalized Interest on Equipment-Purchase Funds. For reasons outlined hereinbefore, it is found that the capitalized interest allowance on TWA's equipment-purchase-fund deposits should be computed on the basis of use of equity funds, Appendix D reflects adjustment of Bureau Counsel's computations to provide for this treatment of capitalized interest.

Allocation of 1946 Tax Refund. TWA suffered losses in 1946 and received a refund of $3,016,000 in that year of 1944 and 1945 Federal income taxes pursuant to the loss-carry-back feature of the income-tax

law. Of this total, $393,000 is allocable to the period between January 1 and February 4, 1946, and $2,623,000 to the part of 1946 here under consideration; i.e., the period from February 5, 1946, to December 31, 1946. TWA contends that, if the refund is to be credited to the year 1946, it must be allocated between those elements of its 1946 operation that gave rise to the loss-carry-back credit.[17] TWA points out that Bureau Counsel argues that $1,130,000 of TWA's domestic loss in 1946 was due to the pilots' strike, and a further $1,180,000 was due to unexplained differences in cost level but that Bureau Counsel assigns no part of the tax credit to these losses. It takes the position that Bureau Counsel erroneously assigns the full tax credit against the $5,040,000 of allowable losses during 1946. TWA contends that the proper credit should not exceed $2,016,000 (based on the 1946 tax rate of 40 percent applied to the above allowed loss) and that the remaining tax credit should be assigned to losses not allowed for rate purposes.

Bureau Counsel believes that TWA's claim is at variance with the actual tax policy which the Board has followed since the *Western-Inland Case*.[18] The Bureau points out that the Board passed on the point now raised by TWA in the *Western-Inland Case* and refers to the following language of the Board in that opinion:

> "The one substantive argument the carriers made against the application of a method which is designed to establish actual tax liability is that rather

17 TWA originally argued that the refund should be treated as a reduction of 1944 and 1945 taxes and assigned to those years rather than to 1946. However, this contention was rejected by the Board in its Opinion of December 20, 1954, (Order No. E-8833, Opinion, Page 117).

18 14 C.A.B. 243 (1951).

than avoiding a windfall to the carrier, such a method 'punishes the carrier twice.' The carriers' view is that not only does the airline suffer the usual disallowances of expenses incurred and paid in the course of business but not recognizable for ratemaking purposes, it also fails to receive the tax allowance which under the constructive method helps cushion the effect of such disallowances. What Western and Inland are insisting on therefore is that for every dollar disallowed for ratemaking purposes—e. g., an expense incurred because of uneconomic or inefficient management—there must be returned to the carrier an amount representing Federal income taxes on that dollar even though no taxes have been, or will be, paid on the dollar. (There is normally no tax liability because the Bureau of Internal Revenue usually allows the item to be deducted for tax purposes). The constructive method is thus revealed as a convenient vehicle for reimbursing carriers for substantial parts of funds disallowed by the Board in accordance with the ratemaking standards of the Act. The carriers characterized the denial of this kind of reimbursement as 'punishing' the carrier. On the contrary, we consider such allowances gratuities which we can no longer tolerate."[19]

The above decision of the Board is directly in point and covers the arguments presented by TWA. Accordingly, the amount of TWA's actual tax liability in 1946, as changed by the above refund, allocable to the period here under consideration (the $393,000 portion of the refund allocable to the period January 1, 1946, to February 4,

[19] 14 C.A.B. 243, 253 (1951).

1946, has been excluded) will be considered in determining the amount of domestic profits available for offset against the transatlantic subsidy.

14656

Book Profits from Sales of Aircraft and Parts. In 1951, 1952, and 1953, TWA made sales of Douglas DC-3 and Boeing 307 aircraft and parts for $1,783,331 in excess of the book value. The property cost $6,899,453, had been depreciated through charges to depreciation expense totalling $6,589,994 to a book value of $309,459, and was sold for $2,092,790. TWA argues that these book profits in 1951, 1952, and 1953, should be treated as a correction of depreciation taken in previous years and should be credited to those years. Bureau Counsel argues that the Board has consistently included the full amounts of both gains and losses on disposition of operating equipment in mail-rate determinations to the extent that such gains and losses fall in open periods, without regard to the period in which depreciation was taken.[20] It also points out that acceptance of TWA's position would result in a double recoupment of this equipment investment by TWA.

TWA produces several arguments on the appropriate accounting technique of handling this item. In appraising the proper accounting technique, an important matter not here fully developed would include a determination of whether the profit was due to overstatement of depreciation throughout the elapsed life or to some relatively current and unusual development. However, it is not necessary to pass upon these arguments insofar as the present case is concerned. The problem is whether the profits should be considered as income during the period beginning January 1, 1951, and

---

20 *Pennsylvania-Central Airlines Corp., Mail Rates*, 4 C.A.B. 22, 30 (1942); *Transatlantic Final Mail Rate Case*, Order No. E-8833, December 20, 1954, Opinion, p. 110, footnote 155.

ending December 31, 1953, or whether some 86 percent should be spread back over previous periods as reduction of the depreciation expenses. Large portions of these previous periods have already been screen the Board for ratemaking purposes, and the revenue and expenses have been appraised on the basis of the depreciation charges which resulted in the book values that have been indicated above in computing the 1951, 1952, and 1953 profits. It obviously would be improper for the Board now to make the depreciation adjustment suggested by TWA and permit the carrier to recoup its investment against income twice. Accordingly, TWA's contention must be rejected, and the full book profit must be considered.

Offset of Domestic Earnings for 1953. TWA refers to the Board's order of December 20, 1954, asserts that the aggregate mail payment awarded to TWA for 1953 was $2,227,000, and points out that in the fourth quarter the final service rate of $.85 per ton-mile for TWA's International Division produced $1,383,000 in mail pay as compared with the $2,227,000 subsidy for the full year. TWA argues that it received no subsidy on its International Division in 1953; that it stopped receiving subsidy in 1952; that, no subsidy having been received for 1953, there is nothing against which to offset any excess earnings of TWA's Domestic Division for 1953; and that the earnings for that year must be therefor excluded from consideration in this case. Bureau Counsel contends that the Board must here consider the need of TWA for the review

period as a whole, rather than on the basis of any isolated part thereof. The Board passed on this specific point in

its opinion of August 20, 1955, in the present proceeding (Order No. E-9530, dated August 30, 1955, Opinion, p. 7). The Board decided that, if it permitted TWA to receive a service rate for transatlantic operations for 1953 without offsetting the excess earnings over the carrier's need for that year against the subsidy requirements of the division for prior years, the carrier would receive more than its statutory need for the period as a whole. It found that such a result would be inconsistent with sound ratemaking principles. Pursuant to that decision, the Domestic-Division earnings of TWA for 1953, which is one of the years included in the review period, will be considered in determining the amount available for offset.

14659

RATE OF RETURN

Bureau Counsel proposes that the amount of excess earnings of divisions other than the transatlantic available for offset be determined by allowance to TWA of an 8-percent return on its allowed investment in domestic operations and by allowance to Pan American of a 10-percent rate of return on its investment in the other divisions being reviewed. Bureau Counsel shows that the Board almost uniformly applied throughout the review period an 8-percent rate of return for subsidized domestic trunkline carriers for future rate periods.[21] It also shows that the Board allowed a 10-percent rate of return for international operations for future periods prior to Janu-

---

21 *All American Aviation, Inc.*, 8 C.A.B. 805, 810 (1947); *Braniff Airways, Inc.*, 11 C.A.B. 431, 436 (1950); *Continental Air Lines, Inc.*, 11 C.A.B. 487, 505 (1950); *Colonial Airlines, Inc.*, 15 C.A.B. 279, 319 (1951); *Northeast Airlines, Inc., Mail Rates*, Dockets Nos. 1932 and 1890, Order No. E-7368, May 11, 1953, (Provisional Statement, p. 30), finalized by Order No. E-7443, June 5, 1953.

ary 1, 1954.[22] The Bureau refers to the Supreme Court's decision in *C.A.B.* v. *Summerfield,* 347 U.S. 67 (1954), which holds that the carrier's need is a limiting factor in the sense that the subsidy may not exceed it. The gist of the Board's decision of December 20, 1954, in the instant proceeding is that the carrier's needs have been met when it has been provided with its operating expenses, incurred under economical and efficient management, plus an adequate return on its investment.[23]

14660

The Bureau refers to the extensive evidence in the prior phases of this proceeding on the subject of the fair rate of return, and it refers to the Board's conclusion in its opinion of December 20, 1954, that a return of 7 percent for past periods and 9 percent for future periods was fair and reasonable with respect to the investment allocable to the transatlantic operations. It points out that the Board noted in its opinion that the domestic trunkline industry had between 1939 and 1953 reported earnings of 8.6 percent on investment, that with those earnings the industry had exhibited tremendous growth, and that there had not generally been any inability on the part of the trunkline industry, or of Pan American and TWA, to obtain necessary financing for replacement or expansion needs.[24] The Board therein noted that it was reducing the rate for future periods from 10 percent to 9 percent, in recognition that the uncertainty and risks formerly inherent in inter-

22 *Pan American-Grace Airways, Mail Rates,* 3 C.A.B. 550, 590 (1942); *Colonial Airlines, Inc., Bermuda Mail Rates,* 12 C.A.B. 737, 754 (1951); *Pan American World Airways, Inc., Trans-Pacific Mail Rates,* 14 C.A.B. 818, 835 (1951); *Pan American World Airways, Inc., Alaska Mail Rates,* 15 C.A.B. 173, 186 (1952); *Pan American World Airways, Inc., Latin American Division, Mail Rates,* Docket No. 3308, Order No. E-7650, August 19, 1953, (Provisional Statement, p. 18), finalized by Order No. E-7673, September 1, 1953.

23 Order No. E-8833, dated December 20, 1954.

24 Id. at pages 87-8.

national operations greatly exceeded those of today.[23] It points out that the Board analyzed cost-of-capital evidence in the record and after consideration thereof concluded that the cost of capital supported a 9-percent rate of return in the international operations. The Bureau also adverts to the Board's statement that in establishing the 9-percent rate for the international operations it had given consideration to the 8-percent future rate applied for domestic carriers, and that nothing in the decision was intended to derogate from this established rate. The Post Office takes the same position as Bureau Counsel and advances substantially the same arguments with respect to both carriers.

14661

TWA's Rate of Return. The Bureau contends that the above findings of the Board support a return of 8 percent on investment for TWA's domestic operations in view of the lesser risk associated with the domestic operations as compared with international operations. In support of the contention that this return falls within the range of capital costs for the Big Four trunkline carriers as found by the Board in the opinion of December 20, 1954, adjusted to eliminate international risks, it shows that such an 8-percent return on investment produces a return of 13.06 percent on the stockholders' equity allocable to the domestic division. The Bureau recognizes that the present case deals with past periods and that the Board has normally allowed a return of 7 percent for past-periods domestic operations. However, while there is not herein involved the uncertainty in forecasting future results that is normally found in appraising future rates, the Bureau believes that if the carrier's other division had sustained net losses during the review period, the Board could not have

[23] Id. at pp. 88-9.

made up such losses in the offset period. Therefore, it believes that the risk that the carriers took on previous occasions with respect to closed rates more closely approches that of a future period than that of a past period. It concludes that the use of a rate of return designed for future rates is appropriate.

The Bureau refers to the Board's language in the order dismissing the *General Passenger Fare Investigation*,[26] in which the Board stated that it was allowing domestic passenger fares to remain unchanged despite the excessive earnings of the trunklines, that a compelling consideration in

14662

this decision was that better than average earnings in good times are required to offset less than average earnings in poor times, but that, should the earnings fall markedly in the future, the carriers would be expected to absorb such losses without resort to fare or mail-rate adjustments unless the earnings were lower than adequate over a reasonably extended period. The Bureau recognizes that the offset of TWA's domestic earnings in excess of an 8-percent return on investment will impair its ability to cope with periods of poor earnings in the future, and that it is, therefore, possible that TWA's domestic division might require subsidy in the future before other domestic airlines which have been permitted to retain excessive earnings. The Bureau, however, regards this as an inevitable result of the decision of the Supreme Court in *C.A.B.* v. *Summerfield*, 347 U.S. 67 (1954), under which the Board must review TWA's system as a whole and, under which, the entire system during the period 1946-1953 was, in effect, required to be treated as a subsidized system.

TWA, opposing the position of Bureau Counsel, con-

---

26 Order No. E-7376, dated May 14, 1953.

tends that its earnings have not been in excess of reasonable earnings, and that none should be offset against the subsidy. As its first point of reliance, TWA argues that under the criteria established by the Board its domestic division has no excess earnings. In support of this contention, it asserts that the range of earnings held reasonably in the *General Passenger Fare Investigation* included, among other things, earnings for the industry as a whole of 12.04 percent in 1950, 14.9 percent in 1951, and 14.3 in 1952.[27] It points out that TWA's earnings have been less than those approved by

14663

the Board in the *General Passenger Fare Investigation* in that the trunkline industry as a whole attained an 8.3-percent return on investment in the period 1939 through 1952 in comparison with which TWA had earnings of 4.8 percent. In further support of its contention, TWA argues that the range held reasonable in service-mail-rate proceedings includes numerous instances in which the overall return was well above 10 percent. TWA also submits previous Board decisions in subsidy cases which have permitted earnings above that now proposed by the Bureau.[28] Finally, TWA contends that the Board has permitted earnings far in excess of 8 percent to remain unchanged by refraining from instituting a proceeding for a review of rates under which higher earnings were realized.

Second, TWA argues that it must be allowed to retain earnings up to the level of its competitors. It refers to *Bluefield Water Works & Improvement Company* v. *Public*

---

27 Order No. E-7376, *supra*.

28 The reference here is to the sliding-scale rates, designed to permit increased profits for higher load factors, and the *American Airlines Mail Rate Case*, 3 C.A.B. 770 (1942) in which the earnings were found excessive but recapture was decided against. The cases are not analagous to the present situation.

Service Commission, 262 U. S. 679, 692 (1922), in which the Supreme Court said:

> "• • • A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in *other business undertakings* which are attended by corresponding risks and uncertainties."

It also refers to the portion of the Supreme Court's decision in *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) in which the Court holds that "the return to the equity owners should be

14664

commensurate with returns on investments in other enterprises having corresponding risks." TWA argues that these standards render it legally impossible to find that TWA's domestic division had any excess earnings during the review period. It shows that its adjusted rate of return during the review period was only 10.21 percent as compared to 14.20 percent for the Big Four, exclusive of TWA, and 13.66 percent for the trunkline industry. It points out that throughout the review period the Board has grouped TWA's domestic route along with those of American, Eastern, and United as having comparable risks and uncertainties and has applied uniform mail rates to all four carriers. TWA insists that, having fixed the same rates for TWA and judged TWA by the same cost standards, the Board cannot now legally find that TWA's earnings can be judged by a different standard and that regardless of the earnings of these other business undertakings TWA should be held to an 8-percent rate on

investment. TWA declares that most of its competition, domestically, is with American and United, the largest and strongest carriers in the country, and that it must have the same opportunity to acquire equipment and to have comparable earnings in order to be able to take the risks involved in competing.

TWA relies upon the testimony of Mr. Titus Fowler, a member of the largest brokerage firm in the country, that if TWA were held to a lower rate of return than the other carriers, it would be at a competitive disadvantage in raising capital.

Third, TWA argues that the cost-of-capital approach cannot be used to determine proper level of earnings for offset purposes. It contends that the cost of capital of the Big Four during the period 1949-1954

14665

as reviewed by the Board rested on the actual earnings during those years and that during this period the average earnings reported were 11.8 percent. It contends that the cost of capital on the basis of such a high level of earnings will be lower than the cost based on reduced earnings.

Bureau Counsel asserts that the position of TWA to the effect that its earnings are not excessive if they are less than the profits earned by other competitive air carriers must be rejected because of the Board's finding in the present case as to the fair rate of return sufficient to attract capital. The Bureau attacks the testimony of TWA's Witness Fowler that action by the Board holding TWA to a rate of return lower than that of its competitors would impair its ability to finance. It points out that he offered no factual testimony respecting TWA or the airline industry, and that his testimony really amounts only to the proposition that a company with a good earnings record has a lower capital cost than companies with poorer

records. Bureau Counsel contends that the issue in a rate case is not what rate of return will produce the lowest capital cost for the utility. It points out that if such were the basis of determination, a 50-percent return on investment could be justified on the ground it may enable the company to raise capital at 3 percent. The Bureau contends that TWA's theory is really only a device to permit the carrier to receive earnings in excess of those required to raise capital on fair terms to its stockholders, and would have the effect of increasing the market price of TWA's stock substantially above book value at the expense of the taxpayer.

14666

Bureau Counsel contends that the only analysis of record bearing on the point reveals facts opposite to those contended by TWA.[29]

Bureau Counsel brings out that the witness conceded that the general public is not too concerned with the earnings rate on investment and admitted that investors' services usually do not supply such data. The Bureau brings out that the witness's firm (Merrill Lynch, Pierce, Fenner, and Beane) rated TWA's stock in a May 1955 pamphlet as the "relatively most attractive" airline common stock in

29 The Bureau argues that the only analysis presented in the earlier phase of this case bearing on this point tends to disprove Mr. Fowler's assumption (Tr. 194-5) that a high earnings rate results in low earnings-price ratios. PAA's Witness Badger submitted financial data relating to the chemical, machine tool, and tobacco industries in Exhibit PA-200. In each group, the company with the highest return on investment (Abbott Laboratories, Ex. PA-200, p. 29; The National Acme Company, Ex. PA-200, p. 33; and Philip Morris Co., Inc. Ltd., Ex. PA-200, p. 37) had a substantially higher long-term earnings-price ratio for the period 1942-1951 than the other companies in the group. For example, for the period 1942-51, Abbott Laboratories, which earned 21 percent on equity capital or approximately twice that of each of the other two chemical companies in the group, had an earnings-price ratio of 6.59 percent for the same period, compared with its competitors' ratios of 5.56 percent and 6.39 percent for the same period. No explanation of this phenomenon was supplied for the record. The Bureau argues that the answer may lie in the investor's fear that the high-profit company is vulnerable to competition and the expectation that the companies with lower earnings will improve.

its category. Bureau Counsel contends that TWA has not shown that it is prejudiced because of the retention by other carriers of earnings which the Board has characterized as excessive.

Arguing against the contention of TWA that it needs a larger rate of return than 8 percent because its earned surplus is less than that of its competitors, the Bureau asserts that this low earned surplus is a reflection of the smaller size of its operations and, also, is attributable in

part to amounts of expenses incurred by the carrier but not recognized by the Board because of the carrier's failure to meet standards of honest, economical, and efficient management.

The Bureau refers to the *Chicago & Southern Air Lines, Mail Rate Case,* 4 C.A.B. 419, 421 (1943), in which the Board stated:

> "Nor does the respondent's contention that it is entitled to a rate which will place it on a financial parity with other air carriers that have accumulated large reserves impress us as relevant to the question of a fair and reasonable rate. The respondent states that the accumulation of such reserves by American Airlines, Inc. and Eastern Airlines, Inc., has made it necessary for it to be placed in 'a comparable position' with them. This position of the respondent amounts to a contention that the Board should undertake to see that all carriers achieve a state of complete equality of financial position. Even if it were within the realm of practical accomplishment, the Board does not consider that any such duty was imposed upon it by the Civil Aeronautics Act, and finds no authorization therein to undertake any such program. The important con-

sideration is that the rate fixed for the respondent shall place it in a position whereby it is enabled to enter the private capital market and obtain needed funds for its legitimate purposes at reasonable rates."

Looking at TWA's argument that the fluctuations of earnings from year to year in the airline industry make unreasonable the use of a fixed rate of return over a short period, the Bureau points out that TWA has the legal right under Section 406(b) to reimbursement for its need under honest, economical, and efficient management, and this argument must therefore fail.

The Bureau points out that TWA has cited numerous cases in which the Board, in establishing service mail rates, indicated the overall return to the carrier on its entire operation. The Bureau asserts that these cases are not in point since they involved nothing more than the determination of a fair and reasonable compensatory service rate for the carriage

14668

of mail, and there was no issue before the Board of reducing the carrier's service rate below a fair and reasonable level so as to bring the overall earnings rate to a reasonable level.

The Bureau asserts that materials presented by TWA showing comparisons of the air transportation industry with other industries with respect to operating ratio, return on investment, profit margin, and dividends are the same as was previously offered by TWA in the earlier phase of the case and have already been rejected in favor of the more direct cost of capital approach.

Pan American's Rate of Return. The Bureau of Air Operations shows that the Board, from the start of World

(14668, 14669)

War II until the period beginning January 1, 1954, used a 10-percent rate of return for international carriers without exception.[30] It points out that 10 percent was used by the Board in determining the amount of excess earnings in the first *Panagra Mail Rate Case,* 3 C.A.B. 550, 558 (1942) as well as in the first *LAD Mail Rate Case,* 3 C.A.B. 657, 666 (1942). It contends that such a rate of return for Pan American is amply supported by the Board's finding in its opinion of December 20, 1954, in this proceeding. It supports a rate appropriate for future rate determinations for periods prior to 1954 on the ground that the risks here involved more nearly approach those of a future period than those of a past period for reasons set forth in discussing Bureau Counsel's position on a proper rate of return for TWA.

14669

Pan American opposes the Bureau of Air Operations' approach that allowable earnings in excess of 10 percent on investment are excess and available for offset. As a first argument, it contends that the Board has already held that the amount of excess earnings may not be determined by mere reference to the rate of return used in establishing future mail rates. It refers to the Board's opinions in the *Braniff Final Mail Rate Case,* Order No. E-7815, dated October 15, 1953, and the *Delta Mail Rate Case,* Docket No. 6110, Order No. E-7738, dated September 21, 1953, in which the Board pointed out that a determination that earnings are excessive in the sense that they are available for, or should be offset against, subsidy requires more than a mere subtraction of actual or estimated profits from an estimated rate of return on investment.

Second, Pan American asserts that the wide zone of

30 See footnote 22, *supra.*

reasonableness in final prospective rates implicit in the Board's ratemaking policies makes the proposal of the Bureau unsound in suggesting that earnings in excess of 10-percent return on investment are available for offset. In connection with this argument, Pan American points out that it is unreasonable to anticipate that a carrier will realize exactly the rate of return used in establishing a future mail rate because of the many variable and fluctuating factors which must be appraised in a forecast of future operating results. It then points out that the carrier bears the risk that earnings will fall below the level forecast by the Board, and the Supreme Court has held that the Civil Aeronautics Act does not contemplate a cost-plus system of regulation with respect to the

14670

administration of the mail-pay subsidy.[31] It contends that as a necessary corollary, the Board has given the incentive an opportunity to the carriers to earn more than the rate used when establishing future mail rates. It refers to several of the Board's decisions in which such a policy was announced, including that in an early case involving Pan American's Atlantic mail rate in which the Board stated:

> "We believe that as a matter of general principle the return to be received on capital invested in the air transportation industry should depend in a large degree upon the commercial development of the service and the attraction of commercial traffic. In fixing a rate, the Authority believes the benefits of an increased volume of passenger, express, and mail traffic should inure to both the carrier and the Government; to the former by an augmenting of the return as commercial revenues increase, and to the

[31] *TWA* v. *C.A.B.*, 336 U.S. 601.

> latter by a reduction of the financial dependance of the air transportation industry upon mail compensation in excess of the amount of net postal revenues."[32]

It refers to many instances in which the Board has refrained from reopening rates as soon as they produced earnings above the forecast rate of return and other instances in which the carriers have refrained from filing a mail-rate petition for considerable periods after earnings have fallen below the allowed rate-of-return level. It argues that, because of the great fluctuations of earnings of airlines, the achievement of a desired level of earnings over an extended period of time requires the retention of substantially higher earnings during portions of such periods, and it, too, adverts to the Board's opinion accompanying its order dismissing the *General Passenger Fare Investigation*[33] in which

14671

among other things, the Board stated:

> "There is another factor which leads us to the conclusion that it is in the public interest, for at least a reasonable period, to permit fares which result in returns which would be considered excessive as an average return over an extended period. As the figures in Appendix A show there have been substantial variations in airline earnings over the history of the industry. Although for certain periods they have been what might be considered excessive, over the entire period the average return has not been *prima facie* unreasonable. As the motions to dismiss point out, better than average earn-

32 I.C.A.A. 220, 254 (1939).

33 Order No. E-7376, dated May 14, 1953.

ings are required in good times to offset less than average earnings in poor times."

Pan American believes that with mail rates fixed separately for its four different operating units it should be allowed higher than average earnings in some units to balance lower than average earnings in other units so as to achieve reasonable earnings as a carrier. It protests that reasonable average earnings for a multi-division carrier such as it is cannot be attained if all above-average earnings of its closed divisions are applied against deficiencies of open divisions and the deficiencies of closed divisions are not met.

Third, Pan American contends that Bureau Counsel's proposal would unfairly prejudice a multi-division carrier as against a single-division carrier in that the new risk of hindsight screening would result in shearing off any higher than average earnings of closed divisions, and as a result the multi-division carrier would be unable to reach the intended rate of return on a carrier-wide basis because of the lower than average earnings at certain times.

Fourth, Pan American maintains that the Bureau's reliance on cost of capital is badly misplaced, in that the argument erroneously assumes that Pan American earnings have met its cost of capital. It analyzes

the Board's order of December 20, 1954, in the *Trans-Atlantic Final Mail Rate Case,* concluding that the Board determined that the reasonable earnings rate on common stock was 13.36 percent in connection with a future rate of return beginning in 1954. Pan American states that there has been only one year since 1946 in which its return on equity rose as high as 10 percent, that the average from 1946 to 1953 was only 5.4 percent, and that during

the period from 1951 to 1953 its return on equity was only 7.9 percent. It argues that these overall returns must be viewed rather than the returns for any specific division, that cost of capital can have meaning only as applied to the carrier as a whole, and that this must be done on a basis of a review of all divisions over an extended period.

Pan American takes the position that its earnings have not been in excess of its "needs" and that there are, therefore, no excess earnings to apply against subsidy for its Atlantic Division. In support of this position, Pan American asserts that its need must be determined in the light of its ability to obtain necessary capital on fair terms. It refers to Board and Court opinions in support of this contention. It points out that the Supreme Court, in the *Hope Natural Gas Case,* 320 U.S. 591, stated:

> "* * * the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

Pan American emphasizes that the maintenance of its credit and its ability to attract capital is exceptionally important at this time,

14673

in view of the large amounts of capital expenditures which will be required in the next few years. Reference is made to the fact that the present program of the purchase of DC-7B and DC-7C aircraft will require expenditures of approximately $110,000,000 during the period 1955, 1956, and 1957, and that a very expensive program in connection with the procurement of jet aircraft, expected to cost $5,000,000 each, is planned.

Second, Pan American argues in support of its need for

all earnings received, that it is already in a disadvantageous position to obtain necessary equity financing on fair terms. It declares that its dependence on subsidy is an adverse factor shared by no other major U. S. Flag airline. Looking at total investment, it asserts that its annual rate of return was 5.9 percent between 1942 and 1945, 3.9 percent between 1946 and 1953, and 6.8 percent between 1951 and 1953. In comparison it states that the Big Four experienced rates of return of 17.1 percent, 7.5 percent, and 12.6 percent during these respective periods and that the domestic airlines as a whole experienced rates of return of 15.0 percent, 7.6 percent, and 12.9 percent. Looking at the annual rate of return on equity investment, Pan American states that it received 5.4 percent during the years 1946-1953 and 7.9 percent between 1951 and 1953, in comparison with which it states the Big Four received 9.8 percent and 16.8 percent during these respective periods on total stock and 12.2 percent and 20.6 percent on common stock, and during the same periods the trunkline domestic carriers received 9.4 percent and 17.3 percent on total stock and 11.5 percent and 20.9 percent on common stock. Pan American contends that any Bureau Counsel

argument that its poor earnings record cannot be considered on the grounds they reflect in part mail-pay disallowances based on inefficiency should be rejected because mail-pay inefficiency is not inefficiency in a normal business sense, and, in addition, no evidence has been submitted that Pan American has been any more inefficient than any other carrier.

As a third point supporting its argument of need, Pan American alleges that the experience of purchasers of its stock issued in 1945 has been disappointing. In July of that year, Pan American sold some 2,000,000 shares of

stock at $21.50 each, the proceeds of which more than doubled the carrier's net worth. At the present time, the market quotation on this stock is approximately the same as its purchase price. Pan American refers to the testimony of its expert witness that it is not uncommon for growth stock to double or triple in market price over a 10-year period.

The carrier maintains that the action of institutional investors reflects a deteriorating regard for its stock. It shows that as of December 31, 1947, the investment trust holdings of Pan American stock consisted of 127,000 shares, or 2.1 percent of the total number of Pan American shares outstanding. These holdings constituted approximately 9.3 percent of the market value of the total airlines stock portfolios of the investment trusts. In April 1955, the holdings in Pan American had been cut in half, and the approximate market value of the stock amounted to 2.2 percent of the investment-trust holdings of airlines stock. Pan American further contends that the holdings of insurance companies reflect a deteriorating regard for Pan American stock. As of January 31, 1947,

eight insurance companies owned 17,950 shares of Pan American common stock, which was the largest individual airline common stock holding and represented approximately 7 percent of the total investment in this industry. Seven years later, only one insurance company was found holding 100 shares of Pan American stock, which represented only .03 percent of the total airline-industry investment. It was pointed out that in the meantime commitments in the subsidy-free air carriers rose very sharply.

Fifth, Pan American argues that the low market price of its stock in comparison with its book value reflects an adverse investment appraisal. It points out that since 1947

Pan American's stock has sold at the largest discount of any major airline and that it did not reach book value until the end of 1954 after reverting as low as 50 to 60 percent of the book value for many years.

Sixth, Pan American avers that investment in its stock involves risk because of its high operating ratio. It points out that, generally speaking, the operating ratio (ratio of expense to revenue) of electric, gas, and telephone utilities has been in the 70-to-80 percent range in comparison with over 90 percent for the airlines. Within the airlines group, its operating ratio for the period 1946-1953 was 96 percent compared with 90.2 percent for the Big Four and 91.9 percent for all domestic trunklines. It points out that its expert witness considered important the fact that increase of but two percentage points in Pan American's operating ratio would have cut its operating profit in half, and an increase of four percentage points would have wiped it out altogether.

14676

Pan American asserts that a decision that its earnings of the past 8 years have been in excess of its "need" would adversely affect its marketing of additional securities at a fair price. It refers to the testimony of its expert witness that the somewhat improved earnings of recent years and a hope that they would continue was responsible for rekindling investor confidence and that, if the Board were now to determine that the earnings of these years were excessive, investor confidence in Pan American's stock would receive a severe blow.

Pan American advances a contention that its "need" for all of its earnings is shown by the use to which these funds have been applied. Its witness testified that Pan American's earnings during the period from 1951 to 1953 totalled approximately $24,000,000, of which approximately

$10,000,000 were distributed to stockholders in dividends and approximately $14,000,000 were retained in the business. It brought out that the dividend distribution provided stockholders with approximately 2½ percent on the purchase price of the stock marketed in 1945, and about 3½ percent on book value. Pan American's treasurer expressed the opinion that if Pan American had not maintained this dividend policy its stock would have been in a poorer position than it is today. Referring to the amount proposed for offset now, the witness pointed out that $6,000,000 of the total earnings were used to provide funds for the purchase of four DC-6B aircraft and expressed his opinion that the acquisition of these modern aircraft constituted an important step in the development of air transportation.

14677

Bureau Counsel takes the position that Pan American's allegedly poor earnings record cannot be considered in this case. It refers to the fact that Pan American's expert witness agreed that a 10-percent rate of return, if realized over a period of years, would be reasonable, and that the witness complained that Pan American has failed to realize the return theoretically allowed by the Board. The Bureau points out that Pan American's thesis was developed by a showing of facts in a series of exhibits comparing Pan American with other airlines on the basis of earnings, operating ratios, etc., and that these comparisons relate to Pan American's various divisions for periods specifically excluded by the Board from consideration in this case. The comparisons do not adjust Pan American's earnings in recognition of disallowances made by the Board in this and other cases. The Bureau asserts that it would be a mockery of the Board's ratemaking policies to permit Pan American to recoup disallowed expenses

through a return element. It contends that in this case the issues are restricted to the earnings available for offset from the Pacific and Alaskan Divisions during the period beginning January 1, 1951, and from the Latin American Division beginning January 1, 1953, and that the results of other divisions and other periods are not involved.

The Bureau points out that the Board specifically rejected the type of argument now presented by Pan American and refers to the 1943 *Chicago & Southern Mail Rate Case,* 4 C.A.B. 419 (1943), in which the Board, acting on a similar claim, held as follows:

14678

> "That the respondent's need for the current and future period is to be properly measured by a rate calculated to raise its historical earnings from the beginning of its operations from a little less than 8 percent annually, which has been actually realized to date, to 10 percent on respondent's average investment since the beginning of its operations, requires more than simple assertion to give it validity. The carrier offered no support in law or in economics for the proposition advanced. While the financial history of the air carrier industry as a whole is certainly a factor to be considered in determining the amount of return which air carriers need in order to secure capital for future development, and the financial history of a particular carrier is pertinent to the consideration of the earnings which it requires to insure a sound credit position, it does not follow that a carrier requires a rate sufficient to enable it to show the equivalent of a historical profit of 10 percent annually on its average investment for the entire period of its operating history as a necessary condition to its ability to raise needed

capital funds in the future. The mail rate provisions of the Civil Aeronautics Act do not call for what would be in effect a revision of historical earnings so as to reimburse the carrier for inadequate profits received in the past; those provisions require the establishment of present and future rates which will enable the carrier under honest, economical, and efficient management to discharge its public service obligations as specified by the Act. The statutory policy is not remedial of past inadequacies; it is instrumental of present and future accomplishments."

The Bureau contends that Pan American's claim of a deteriorated position in investment sales is belied by an unprecedented long-term borrowing this year in which Pan American was able to borrow $6,000,000 from 18 insurance companies on a private basis at 3¾ percent interest, with the loan to be repaid in installments beginning in the year 1956.

No inconsistency is observed by the Bureau between its proposal to offset the excess of revenues above allowable expenses and a 10-percent return and the Braniff and Delta Mail Rate cases, *supra*. It points out that in those cases the Post Office had contended that

14679

domestic earnings in excess of 8 percent should be offset against international subsidy, that the question of the amount of excess earnings was not reached by the Board because of its policy of refraining from any offset of excess earnings, that the Board properly pointed out that no such determination of excess earnings should be implied, and that the Board further noted that a determination of the amount of excess earnings for offset purposes "obviously

requires more than a mere subtraction" based upon "an estimated return on investment." The Bureau points out that its position herein is obviously based upon more than a mere subtraction of an estimated return.

Conclusion: It is clear that the Board's findings in its previous opinions in this proceeding and in its opinions in other proceedings of which official notice can be taken support the reasonableness for periods prior to January 1, 1954, of a rate of return of 8 percent[34] for TWA's domestic operations and 10 percent for Pan American's international operations. No substantial showings have been put forward by the carriers which indicate that a different result should be applied as to the review periods here under consideration. Much of the presentation involves reargument of points that the Board has already passed upon and concerning which no significant new matter has been submitted.

The carriers' evidence does not justify a finding that they will be unable to obtain capital on fair terms if these rates are applied. Pan American and TWA attempted to show by opinion evidence of expert witnesses

14680

that they occupied relatively unfavorable positions in the view of investors. However, this evidence must be viewed in the light of the facts that the investment firm of which TWA's witness is a member rates TWA's stock as "relatively most attractive" and that Pan American has recently arranged a highly advantageous financing arrangement.

There is little merit in the argument that results of

34 The Board found as recently as May 27, 1955, that an 8-percent return on investment in domestic operations is a proper one for recognition. See *Domestic Trunkline Service Mail Rate Case*, Order No. E-9211, May 27, 1955, p. 10, footnote 7.

operations in periods other than the periods under review must be considered on the ground that fluctuating operating results bring both above- and below-level financial returns, and, therefore, the 8- or 10-percent return on an overall basis is obtained only by looking at long periods. The Board has already decided that it will not review again in this proceeding the periods for which the carriers' mail rates were fixed retroactively, on the ground that all questions relating to the proper mail rates for those periods have been fully litigated in the light of the actual operating results.[35] The periods that are under review represent all periods of operation of Pan American and TWA between 1946 and 1953 except those as to which the Board has already reached a determination, on the basis of a review of past operating results, that the mail pay constituted a reasonable payment under the Act.[36] Any contention that a keyhole view is involved must, therefore, be rejected summarily. The fact that the Board found some of the carriers' expenses not

allowable under the standards of the statute with respect to honest, economical, and efficient management can hardly be used as a ground that such disallowances must be repaid by means of a higher rate of return.

Two aspects are involved in looking at the Board's dictum with respect to mail pay when it dismissed the *General Passenger Fare Investigation, supra*.. The Board indicated that carriers would be expected to absorb losses without resort to fare or mail-rate adjustments unless earnings were below the level necessary to provide a fair

35 Order No. E-8672, dated September 29, 1954, reaffirmed by Order No. E-9282, dated June 7, 1955.

36 It is unnecessary to repeat here the discussion of the Board in its opinion accompanying Order No. E-8672 of September 29, 1954, concluding that the rate of Pan American for January 1, 1946, through April 4, 1948, would be considered to be in the nature of a past-period rate.

return over a reasonably extended period, including both good and bad years. In the first place, the Supreme Court's decision changes TWA's status for the period prior to 1954 from that of an unsubsidized carrier for its domestic system to that of a subsidized carrier for its entire system, including domestic operations. Second, subsidy revenue from the Government is fixed and administered by the Board and is entirely different from commercial revenue. The latter is subject to the vicissitudes of changing economic conditions, and it is necessary to build up surpluses when business is good to carry a company over bad times. Airmail subsidy is not subject to such vicissitudes but is fixed by the Board on the basis of need. It would obviously not be necessary to pay out more than is needed to take care of some future time when less compensation than needed will be paid. To the contrary, a carrier under subsidy has the ever-present support of Section 406 and can petition and obtain from the Board an increase in subsidy if its need increases. Thus, as pointed out by Bureau Counsel, the above dictum in the *General Passenger Fare Investigation* dismissal order has little application to the specific mail-pay problems met in this proceeding. The same reasons nullify the carriers' other arguments on the need for mail-pay

14682

subsidy from this proceeding at higher than needed levels to take care of bad times that may be met in the future. If such future needs develop, they will be the appropriate concern of a further mail-pay proceeding covering the period of the need.

The Examiner here accepts the conclusion of Bureau Counsel and the Post Office that the risks involved in the review periods more nearly approach those of a future rate period than those of a past rate period. In reaching

this conclusion, reliance has been placed in part upon a conclusion that the Board could not reimburse the carrier for its losses if it were found that the divisions screened for offset purposes had received less than needed revenues rather than an excess. TWA indicated disagreement with this latter conclusion but submitted no showing in connection with its opposition. If the above conclusion be wrong and the Board should construe the statute to provide that the carrier could have been reimbursed in this proceeding for losses in its domestic division, then the risk would be different and would probably approach more nearly that of a past than a future period. Accordingly, consideration would then be appropriate as to whether the lower rates of return applicable to past-period determinations should be applied.

In the light of the foregoing findings and considerations, it is concluded that it is reasonable to allow a rate of return of 8 percent on TWA's investment allocable to its domestic division operations here under review and a rate of return of 10 percent on Pan American's investment allocable to its operations now subject to review.

14683

FINDINGS

On the basis of the foregoing facts, considerations, and conclusions, and the entire record herein, it is found that:

1. The operating divisions of Pan American, other than the transatlantic, have $13,490,000 excess earnings with which to reduce the subsidy requirements of Pan American for transatlantic service.

2. The operating divisions of TWA, other than the transatlantic, have $8,715,000 excess earnings with which to reduce the subsidy requirements of TWA for transatlantic service.

(a)

Excess Earnings of Pan American Divisions Proposed by Bureau Counsel For Offset Against Atlantic Division Mail Pay

(000)

	1951		1952		1953			Total Years 1951-1953
	Pacific	Alaska Last 6 Mos.	Pacific	Alaska	Pacific	Alaska	LAD	
Reported net income before taxes	$ 6,679	$ 644	$ 7,262	$ 521	$ 7,116	$ 868	$ 7,664	$30,254
A. Accounting Adjustments per PAA Stip. I as Revised:								
1. Depreciation reduction re. AOA assets	149	—	212	—	212	—	—	—
2. Retirement gain re. AOA assets	—	—	8	—	—	—	—	—
3. Retirement gain included in 1952 period	—	—	—	—	—	—	−606	—
4. Nonoperating items:								
a. Interest expense	13	—	−2	—	—	—	5	—
b. Other nonoperating expense	7	—	1	—	2	—	28	—
5. Surplus adjustments:								
a. Philippine franchise tax refund	88	—	21	—	—	—	—	—
b. Return premium aircraft hull insurance[1]	—	—	157	12	—	—	—	—
c. Insurance recovery Wake Island Typhoon damage	—	—	115	—	—	—	—	—
d. Adjustment resulting from settlement with Panair do Brasil in connection with joint facilities charges 1948-1952	—	—	—	—	—	—	78	—
e. Accrued vacation pay	−83	−15	−94	−18	—	—	—	—
f. Elimination of engine overhaul reserves	271	—	−148	—	—	—	—	—
6. Amortization B-377 preoperating expense[2]	−119	—	−119	—	−119	—	—	—
B. *Additional Adjustments for Rate-Making Purposes*								
1. Prorate of System G & A expenses as agreed to by PAA for Atlantic Division Adjustment:								
From Exhibit BC-133A	3	—	3	1	—	—	—	—
From Exhibit BC-135A	6	1	6	1	—	—	—	—
2. Miscellaneous expenses directly assigned per Exhibit BC 402	17	1	15	1	12[3]	—	32	—
3. Unsupported expenses relating to Docket 8500	—	—	—	—	—	—	9	—
4. System expenses not allowable for rate-making purposes[4]	—	—	—	—	17	3	80	—
5. Salaries and expenses of J.C. Cone and W. J. McEvoy	10	1	11	2	15	2	26	—
6. Accruals for Philippine remittance tax	21	—	40	—	49	—	—	—
7. B-23 executive aircraft less 20% credit for executive travel	11	1	10	2	[5]	[5]	[5]	—
8. IHC survey expense	—	—	—	—	1	—	1	—
9. Payment on incompleted contract with Historians, Inc.[6]	—	—	—	—	5	1	9	—
10. Unexplained public relations expenses[7]	—	—	—	—	4	1	8	—
11. DC-4 engine overhaul expense applicable to 1953 but recorded in 1954	—	—	—	—	−52	—	—	—
12. Allocation of management expense to IHC[8]	—	—	—	—	6	1	8	—
LAD Adjustments								
13. "Trackage" pilot pay[9]	—	—	—	—	—	—	49	—
14. DC-3 total maintenance cost over $25 per hour[10]	—	—	—	—	—	—	133	—
15. Reversal of net adjustment of L-49 hull depreciation by PAA to reflect normal depreciation (after 15% residual value) instead of 3-year life from 1/1/53	—	—	—	—	—	—	769	—
16. Elimination of DC-4 FESPA depreciation for last six months 1953	—	—	—	—	—	—	536	—
17. Elimination of C-46 FESPA depreciation for entire year 1953	—	—	—	—	—	—	199	—
18. Depreciation related to excess book value of AOA assets over PAA purchase price[11]	—	—	—	—	—	—	26	—
19. L-49 depreciation suspended during AOA grounding	—	—	—	—	—	—	−43	—
20. Selling expense in excess of 10% of commercial revenues (Exhibit BC 406)	—	—	—	—	—	—	545	—
21. Reversal of DC-6B introductory costs transferred from deferred to operating expenses	—	—	—	—	—	—	97	—
22. Allocable portion of reversal of system cashiers expense reclassified by PAA	—	—	—	—	—	—	50	—
23. Accrual of L-49 maintenance expense related to Cubana contract	—	—	—	—	—	—	−50	—
24. Havana Airport rental income not accrued by PAA[12]	—	—	—	—	—	—	247	—
Amortization of capitalized interest on DC-6B equipment purchase funds	—	—	−1	—	−2	−1	−10	—
Total adjustments	$ 389	$ −11	$ 285	$ 6	$ 149	$ 7	$ 2,136	$ 2,911
Adjusted net income before taxes	$ 7,068	$ 633	$ 7,497	$ 527	$ 7,265	$ 875	$ 9,800	$33,165
Actual taxes as revised from amounts in PAA Stipulation I and per PAA Information Request (Revised) for 1953[13]	3,309	275	3,204	293	3,449	183	3,553	14,266
Tax effect of Havana Airport revenue adjustment							128	128
Adjusted profits after taxes	$ 3,759	$ 358	$ 4,293	$ 234	$ 3,816	$ 192	$ 6,119	$18,771
10% return on investment (See exhibit BC 405)	2,481	108	2,509	228	2,567	275	3,976	12,144
Excess earnings available for offset	$ 1,278	$ 250	$ 1,784	$ 6	$ 1,249	$ −83	$ 2,143	$ 6,627
Excess earnings plus tax effect @ 52%								$13,806
Recognized investment (Exhibit BC 405)	$24,814	$2,159	$25,085	$2,275	$25,670	$2,756	$39,761	

B560

(b)

Excess Earnings of Pan American Divisions Proposed by Bureau Counsel For Offset Against Atlantic Division Mail Pay

Footnotes

[1] Excludes return insurance premium of $169,496 applicable to LAD in 1952, and shown by PAA as a surplus adjustment in 1953. This amount should be included in the determination of the final rate for LAD in 1952.

[2] Represents provision for amortization in future rate of Pacific Division, Order No. E-5882.

[3] Includes adjustments for Alaska Division, not listed separately by Auditors.

[4] 1953 system expense disallowances and allocations to divisions are as follows:

Travel expense, Acct. 6636	$31,000
Legal fees, Acct. 6642	7,500
Membership, Acct. 6664	2,078
Contributions, entertainment, and other miscellaneous, Acct. 6674	40,679
Total system	$81,257
Allocations to Divisions	
LAD 36.932%	$30,001
Pacific 21.204	17,230
Alaska 3.685	3,003

[5] No adjustment required for other divisions since all system B-23 expenses eliminated from Atlantic Division in 1953.

[6] Amount of disallowance and allocation to Divisions is as follows:

	Account 6541		Account 6641	
	Allocation*	Amount	Allocation**	Amount
System expense		$12,558		$12,558
Divisions:				
LAD	37.121%	$ 4,662	36.932%	$ 4,638
PAC	21.713	2,727	21.204	2,663
ALA	3.176	399	3.685	463

* Based on passenger and cargo revenue.
** Based on cash operating expenses.

[7] Amount of disallowance and allocation to Divisions is as follows:

	Account 6541		Account 6641	
	Allocation*	Amount	Allocation**	Amount
System expense		$ 6,894		$13,747
Divisions:				
LAD	37.121%	$ 2,559	36.932%	$ 5,077
PAC	21.713	1,497	21.204	2,915
ALA	3.176	219	3.685	507

* Based on passenger and cargo revenues.
** Based on cash operating expenses.

[8] Management expense allocation to IHC $16,000

Allocation to Divisions:	LAD	36.932%	$ 5,909
	PAC	21.204	3,393
	ALA	3.685	590

[9] "Trackage" pilot pay relates to PAA pilots pay for flights performed by Panagra aircraft and pilots over PAA's route Miami-Balboa.

[10] Excess maintenance expense computed as follows:

		Total Dollars	Per Hour
Reported DC-3 direct maintenance expense		$218,262	$32.72
Indirect maintenance:			
Allocated by PAA on basis of actual Brownsville burden rate applicable to DC-3 maintenance 75.12% of DC-3 labor of $98,242..	$73,799		
MOB overhead of 104.7% allocated to remaining net DC-3 direct labor of $7,590	7,947	81,746	12.25
Total maintenance expense		$300,008	$44.97
Recognized level of maintenance expense		166,775	25.00
Excess expense		$133,233	$19.97

B561

(14685)

(c)

Excess Earnings of Pan American Divisions Proposed by Bureau Counsel For Offset Against Atlantic Division Mail Pay

Footnotes

[13] Depreciation adjustment related to the excess book value of AOA assets over the purchase price has been recomputed in accordance with revised AOA mail pay from the $19,000 figure in the future rate opinion.

[15] The Havana Airport rental income adjustment is computed as follows:

Total amount of rental income for 13-month period from December 1, 1952 to December 31, 1953	$267,241
Less: Amount applicable to December, 1952	20,557
Amount of disallowance	$246,684

[16] Taxes revised as follows:

	Year and Division	(000) Amount per Stip. 1	As Revised	Basis
1951	Pacific	$3,312	$3,309	To eliminate surtax credit
1952	Pacific	3,119	3,204	To revise per adjusted tax return
	Alaska	372	293	To revise per adjusted tax return
		Amount per Info. Request		
1953	Pacific	$3,494	$3,449	To revise per adjusted tax return
	Alaska	191	183	
	LAD	3,632	3,553	

B562

(d)

TRANS WORLD AIRLINES — INTERNATIONAL DIVISION
Reopened Transatlantic Final Mail Rates

Summary of Excess Earnings Available for Offset
(In Thousands)

	1946	1st qtr. 1947	1951	1952	1953	TOTAL 1946-1953
Net income before taxes as reported	$-11,356	$-3,742	$12,702	$13,340	$10,052	$20,996
A. *Accounting Adjustments*						
1. Jan. & 1st. 4 da. Feb. 1946[1]	642					
2. Last 18 da. Mar. 1947		60				
Nonoperating items:						
3. Interest expense	320	163	1,320	1,398	1,344	
4. Non-op. prop. losses	102					
5. Amort. disc. on debt	18	3	32	42	66	
6. Other non-op. exp. (7193)	757		62	12	32	
7. Conversion costs[2]					787	
8. Grounding cost[3]	1,805					
9. Grounding amortization[3]	-90	-90	-271			
10. Integration cost[3]		22				
11. Integration amortization[3]		-2	-188	-188	-73	
Reallocation of Bureau Counsel:						
12. Expenses from Int. Div.			-1,892	-324	-329	
13. Korean Airlift Profit			-427	-232	-94	
14. Out-of-period items	-32	-61				
15. Accrued vacation pay	-93	-18		-234	234	
B. *Additional Adjustments for Rate-Making Purposes*						
1. Depreciation reduction for 15% residual value			$ 110	$ 122	$ 3,161	
2. Cost of pilots strike (See Exhibit BC 423)	$ 1,130					
3. Lockheed 18-08 executive aircraft	55	$ 6				
4. Officers and employees expenses[4]	9	1	15	7	6	
5. Contributions, entertainment, gifts, miscellaneous[4]	12	1	35	35	32	
6. Other promotional and publicity expenses[4]				8	45	
7. Legal and other fees re. financing[4]	1		11	2		
8. Executive Officers' salaries in excess of $65,000			29	30	$ 36	
9. Amortization of capitalized interest on L-749A (from Int'l)			-3	-7	-4	
10. Depreciation adjustments to propellers and radio resulting from transfer of aircraft from Int'l. Div.[5]			-14	-11	-17	
11. Excess expense level adjustment (See Ex. BC 422)[6]	1,116					
Amortization of capitalized interest on equipment purchase funds						
a. L-1049 aircraft				-10	-31	-41
b. M-404 aircraft				-29	-43	-72
Reversal of interest earned on equipment purchase funds						
a. L-1049 aircraft					-60	-60
b. M-404 aircraft			-184	-75		-259
Total adjustments	$ 6,252	$ 85	$ -865	$ 546	$ 5,092	$11,110
Adjusted net income before taxes	-5,104	-3,657	11,837	13,886	15,144	32,106
Income taxes actually paid after Internal Revenue audit[7]	-3,016		4,899	4,607	3,302	9,792
Adjusted profit after taxes	$ -2,088	$ -3,657	$ 6,938	$ 9,279	$11,842	$22,314
8% return on investment	2,030	548	3,823	5,226	6,395	18,022
Excess earnings available for offset	$ -4,118	$ -4,205	$ 3,115	$ 4,053	$ 5,447	$ 4,292
Excess earnings plus tax effect @ 52%						$ 8,942
Recognized investment (Exhibit BC 425)	$ 28,069	$34,782	$47,782	$65,819	$79,939	

Footnotes

[1] Computed on basis of reported net profit after taxes.

Bureau Counsel contends that the domestic operations to be considered should begin February 5, 1946, the date TWA inaugurated scheduled service on its international route. TWA contends that the domestic operations to be considered should begin with the date TWA inaugurated any revenue service on its international route. TWA operated 24,042 international revenue miles in January 1946, producing $115,402 of transportation revenue. These transportation revenues have been credited by TWA to reduce the preoperating costs to be amortized in this proceeding.

[2] Conversion cost adjustment computed as follows:

(e)

Footnotes—(Continued)

Aircraft Type	Amount	Period of Write-off	Amount	Effective Date of Amortization	Amount in 1953
DC-3*	$ 27,860	3 years	$ 9,287	10/1/53	$ 2,322
DC-4	76,430	" "	25,477	1/1/54	
L-049	881,181	" "	293,727	5/1/53	195,816
Total	$ 985,471				$ 198,138
Adjustment	-198,138				
	$ 787,333				

* Figure for DC-3 aircraft adjusted to reflect 4 planes sold in 1953.

[3] From Big Four Mail Rate Case, Order E-5560.

[4] Summary of adjustments in detailed listing previously furnished carrier.

[5] Amounts derived from schedule submitted by carrier to Bureau Counsel in connection with 1953 depreciation adjustment and revisions to carrier's amounts for aircraft transferred from international to domestic operations.

[6] Excess level of expenses include the following amounts:
12 months ended 1/31/47.

Passenger Service	$ 362,000
General and administrative	604,000
DC-3 maintenance - indirect	150,000
	$1,116,000

[7] No allowance made for deferred taxes. TWA is claiming the following amounts:

1951	$ 485,955
1952	1,029,748
1953	1,474,420

(f)

PAN AMERICAN OFFSET AS FOUND BY EXAMINER

PAN AMERICAN — ATLANTIC DIVISION

Reopened Transatlantic Final Mail Rates
Excess Earnings of Pan American Divisions Proposed for Effect Against Atlantic Division Mail Pay

(In Thousands)

	1951		1952		1953			Total Years
	Pacific	Alaska (Last 6 mos.)	Pacific	Alaska	Pacific	Alaska	L.A.D.	1951-1953
Adjusted net income before taxes per Bureau Counsel Brief App. A	$ 7068	$ 633	$ 7497	$ 527	$ 7265	$ 375	$ 9800	$33,165
Adjustments to net income:								
1. DC-3 total maintenance costs over $25 per total hour. Reversal of excess expense disallowance	—	—	—	—	—	—	—133	—133
2. Amortization of capitalized interest on DC-6B equipment purchase funds								
a. Reversal of Bureau Counsel allowances	—	—	1	—	3	1	10	15
b. Revised allowances	—	—	—1	—	—5	—1	—16	—23
Total adjustments	$ —	$ —	$ —	$ —	$ —2	$ —	$ —139	$ —141
Adjusted net income before taxes as revised	$ 7068	$ 633	$ 7497	$ 527	$ 7263	$ 375	$ 9661	$33,024
Actual taxes as revised from amount in PAA Stipulation I and per PAA Information Request (Revised) for 1953	3309	275	3204	293	3449	183	3553	14,266
Tax Effect of Havana Airport revenue adjustment	—	—	—	—	—	—	128	128
Adjusted profits after taxes	$ 3759	$ 358	$ 4293	$ 234	$ 3814	$ 192	$ 5980	$18,630
10% return on investment	2481	108	2509	228	2568	275	3986	12,155
Excess earnings available for offset as revised	$ 1278	$ 250	$ 1784	$ 6	$ 1246	$ —83	$ 1994	$ 6,475
Excess earnings plus tax effect @ 52% as revised								$13,490
Recognized investment as revised	$24814	$ 2159	$25087	$ 2275	$25682	$ 2756	$39859	

Pacific, Atlantic and Latin American Division Investment
1951 - 1953

(In Thousands)

	1951		1952		1953		
	Pacific	Alaska[1]	Pacific	Alaska	Pacific	Alaska	L.A.D.
Working capital per Bureau Counsel	$ 6421	$ 1892	$ 5730	$ 1285	$ 4573	$ 1221	$13632
Less: Adjustments for revised excess earnings available for offset							
a. Reversal of Bureau Counsel adjustment	$ —	$ —	$ 2170	$ 254	$ 3686	$ 214	$ 1 072
b. Revised adjustment	$ —	$ —	$ —2170	$ —254	$ —3684	$ —214	$ —1 001
Total adjustments	$ —	$ —	$ —	$ —	$ 2	$ —	$ 71
Working capital as revised	$ 6421	$ 1892	$ 5730	$ 1285	$ 4575	$ 1221	$ 13 703
Fixed and other investment per Bureau Counsel	$18393	$ 767	$19355	$ 990	$21097	$ 1535	$ 26 129
Adjustments to fixed and other investment							
1. Capitalized interest on equipment purchase fund							
a. Reversal of allowance by Bureau Counsel	$ —	$ —	$ —3	$ —	$ —20	$ —1	$ —52
b. Adjusted allowance	—	—	5	—	30	1	79
Total adjustments	$ —	$ —	$ 2	$ —	$ 10	$ —	$ 27
Fixed and other investment as revised	$18393	$ 767	$19357	$ 990	$21107	$ 1535	$ 26 156
Total investment as revised	$24814	$ 2159	$25087	$ 2275	$25682	$ 2756	$ 39 859

[1] Average investment for last half 1951.

B565

(14689)

(g)

TRANS WORLD AIRLINES OFFSET AS FOUND BY EXAMINER

TRANS WORLD AIRLINES — INTERNATIONAL DIVISION
Reopened Trans Atlantic Final Mail Rates

Excess Earnings of Domestic Division Proposed for Offset Against International Division Mail Pay
(In Thousands)

	1946	1st Qtr. 1947	1951	1952	1953	Total 1946-1953
Adjusted net income before taxes before Bureau Counsel	$—5104	$—3657	$11837	$13886	$15144	$32106
Adjustments to net income:						
Amortization of capitalized interest on equipment purchase funds						
a. L 1049 aircraft—Reversal of Bureau Counsel allowance	$ —	$ —	$ —	$ 10	$ 31	$ 41
—adjusted allowances	—	—	—	—15	—44	—59
b. M 704 aircraft—Reversal of Bureau Counsel allowance	—	—	—	29	43	72
—Adjusted allowance	—	—	—	—51	—77	—128
Total adjustments	—	—	—	$ —27	$ —47	$ —74
Adjusted net income before taxes as revised	$—5104	$—3657	$11837	$13859	$15097	$32032
Income taxes actually paid per Bureau Counsel	—3106	—	4899	4607	3302	9792
Adjusted profit after taxes	$—2088	$—3657	$ 6938	$ 9252	$11795	$22240
8% return on investment	2030	548	3828	5239	6417	18057
Excess earnings available for offset as revised	$—4118	$—4205	$ 3115	$ 4013	$ 5378	$ 4183
Excess earnings plus tax effect @ 52% as revised						$ 8715
Recognized investment	$ 28069	$ 34732	$47782	$65491	$80216	

Recognized Investment for Domestic Division
(In Thousands)

	1946	1947	1951	1952	1953
Working capital per Bureau Counsel	$ 3846	$ 5956	$15571	$11838	$11489
Fixed and other investment per Bureau Counsel	$ 24223	$ 28776	$32211	$53481	$68450
Adjustments to fixed and other investment					
Capitalized interest on equipment purchase fund					
a. L-1049 Aircraft—Reversal of Bureau Counsel allowance	—	—	—	$ —79	$—191
—Adjusted allowance	—	—	—	114	275
b. M-704 Aircraft—Reversal of Bureau Counsel allowance	—	—	—	—180	—253
—Adjusted allowance	—	—	—	317	446
Total adjustments	—	—	—	$ 172	$ 277
Fixed and other investment as revised	$ 24223	$ 28776	$32211	$53653	$68727
Total Investment as revised	$ 28069	$ 34732	$47782	$65491	$80216